Robin Robinson

M&A: A Short-Term Solution *Whose* Time May Be Over

Traditionally, big pharma mergers and acquisitions are a quick fix for failing revenue, but this strategy may, in fact, be the wrong solution for long-term, sustainable growth as the industry moves beyond product centricity.

2009 was punctuated by the latest and greatest round of major pharmaceutical company mergers, with the big three — Merck and Schering-Plough, Pfizer and Wyeth, and Roche and Genentech — shining a spotlight on M&A practices in the industry. In reality, M&A has always been a growth strategy for life-sciences companies, enabling them to add product lines and innovation to grow. Our experts say M&A is a great quick fix, but the industry should be looking for a new resolution to its belt-tightening troubles.

"Pharma companies are pursuing mergers today under the same fundamental strategy they have always been pursued — to buy time," says Roger Longman, CEO, Real Endpoints. "By merging or acquiring another company, the buyer gains revenue, then cuts costs, and as a result, creates greater earnings."

However, this is a short-term fix, Mr. Longman says, and the next step should be to address changes that will improve the company's performance well into the future.

"As far as I can tell, any long-term benefit stemming from a merger is almost never realized because, in effect, the company doesn't change its broken system," he says.

Claudius Wamlek, principal at Oliver Wyman's Delta business, tells PharmaVOICE that synergy calculations show that most M&A transactions should be accretive within one to two years. But for this to bear out in reality, the integration process must be handled successfully, he says.

"Post-deal analysis has shown that more than half of mergers fail to achieve the desired results," Mr. Wamlek says. "This highlights the necessity for careful integration, planning, and execution."

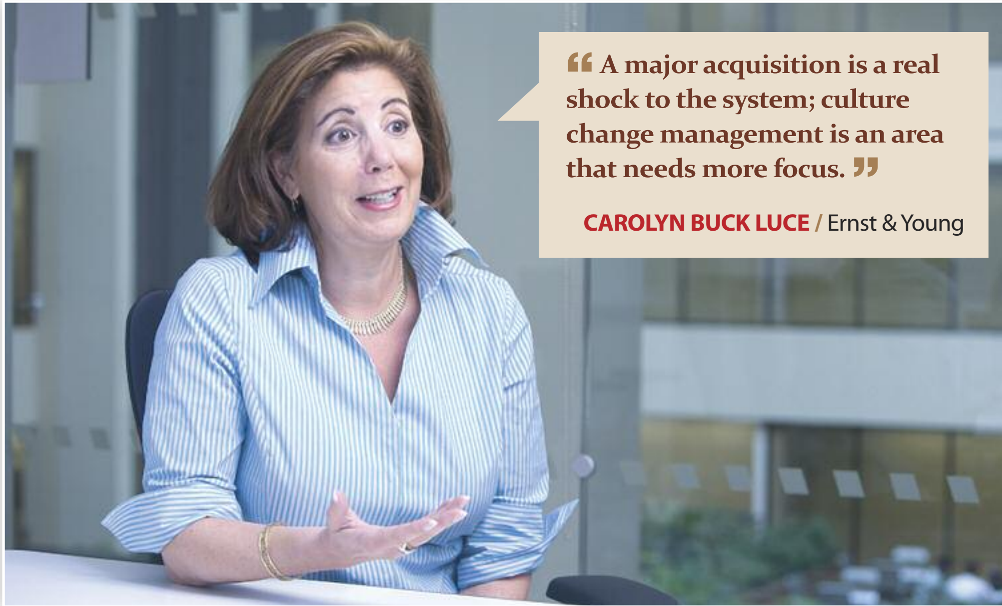
According to Mr. Longman, virtually all mergers are "value destroying," and this is

M&A Factors

A 2009 poll by Cutting Edge Information identified three major factors influencing mergers:

- 64% of respondents said selling companies running out of capital would be a major consideration
- 51% said restricted access to capital would be a major consideration
- 36% said buyer companies with large cash reserves shopping for value-priced acquisitions would be a factor

Source: Cutting Edge Information. For more information, visit cuttingedgeinfo.com.



proven when, several years after the merger, the “new” company holds less value than the combined value of the two independent companies pre-merger. The only way out of this spiral is to focus on improving the existing company, he says.

To inspire confidence within the investment community to continue to invest, the executives of merged companies need to strategically change how their businesses are run and structured.

In the short run, earnings can be improved by cutting costs, especially by reducing headcount, Mr. Wamlek says. In the longer term, realizing sales synergies could generate higher revenue.

“For example, a company could offer a broader and more attractive product portfolio, sell into more markets, or launch more products more quickly,” he says.

As an alternative, Mr. Longman suggests that large companies split up into many smaller companies and create a holding company that owns shares of a group of smaller publicly traded units.

“The pharma industry needs to be made off smaller, not larger companies,” he says. “This is the single-most important alternative that merged companies should be exploring right now.”

It is not an easy solution, but it can be done, he says. For example, companies should rethink their R&D processes and investigate buying options into other companies’ R&D structures, rather than supporting a large internal organization.

“If I were running Merck, Pfizer, GlaxoSmithKline, Lilly, or Novartis, I would dramatically shrink internal operations and put the rest of the money into buying options of other companies’ projects,” Mr. Longman says. “Big M&A deals are not what the business world is interested in now. The focus is on smaller M&A deals that involve acquiring businesses in new areas outside the traditional research-based pharmaceutical industry.”

M&A: The Fallout

- » The pharmaceutical industry ranks as the second-highest job-cutting sector; government/nonprofit sector is No. 1.
- » 50,168 — The number of layoffs in the pharma industry in 2010
- » 35,000 — The collective number of layoffs from Pfizer and Merck, post merger
- » 4,800 — The number of layoffs at Roche in 2010

Editor’s note: Although there are many reasons for layoffs, the predominant factors in the pharma industry have been mergers and downsizing.

Source: Challenger, Gray & Christmas; Cutting Edge Information. For more information, visit challengergray.com or cuttingedgeinfo.com.

But the industry is deeply entrenched in a long-standing M&A culture, and experts, Mr. Longman included, expect to see more mergers in the future.

“Although much of the focus has been on the giant mergers of 2009, there have been many acquisitions in the past two years that have been in response to the approaching era of patent expiration and the need to replenish pipelines,” says Jeremy Spivey, senior research analyst, Cutting Edge Information. “Looking ahead, 2011 promises to continue the cycle of acquisitions, but we expect the trend to intensify in a lower-profile manner than in recent years, until buyers believe they’ve made up sales of soon-to-be expired products and until markets stabilize.”

Moody’s Investors Service reports that 40% of the cash reserve of the country — $1 trillion — is held by the top 20 U.S. companies. Mr. Spivey says this environment could lead to very dynamic M&A activity in the coming year.

“With the biggest days of drug patent expirations around the corner, we are convinced there will be even more consolidation,” he says.

Up until now, the industry hasn’t had much of a choice but to employ an M&A strategy to keep the revenue wheels moving. With the decline of the blockbuster model, the changes in science, and the approaching patent cliff, the industry has been in survival mode. Very soon, however, M&A as a strategy to sustain the growth of pipelines and product portfolios is going to tap out, and the industry should be preparing now to enter an incremental growth phase that Ernst & Young calls Pharma 3.0.

Pharma 3.0: The Next Shift

In the past, the big challenges for pharma companies were building their pipeline and managing the development risks as well as manufacturing a quality drug. From this point on, the challenge will lie in the commercial issue of who will be paying for the drug, says Carolyn Buck Luce, global pharmaceutical sector leader, Ernst & Young.

“Currently, everyone is working on operationalizing their mergers, but the next big shift in the industry will be Pharma 3.0 and M&As will not help with this at all,” she says.

In the future, companies will have to demonstrate that they are delivering healthy outcomes, and they will have to make sure that payers are willing to reimburse for treatments.

“What is interesting about this shift as it relates to M&A is that the industry won’t get to 3.0 through massive acquisitions, but rather through innovative partnerships with traditional and nontraditional players,” she says.

The focus in this new phase of development moves from the products to the patients, which means that soon the industry will be in the outcomes business, Ms. Buck Luce says.

“Pharma will need to move from being product-centric and developing pills and devices, to being patient-centric and delivering and defining better health outcomes,” she says.

This will also include expanding access to underserved populations and markets and meeting unmet medical needs.

“With healthcare reform happening not only in the United States, but around the world, and patients becoming more knowledgeable and having to share more of the cost of their healthcare, the question of who is going to pay for meds is becoming one of the seminal issues for the pharmaceutical industry,” Ms. Buck Luce says.

> “More than half of mergers fail to achieve desired results, highlighting the need for careful integration planning.”
>
> CLAUDIUS WAMLEK / Oliver Wyman’s Delta

> “The M&A trend is expected to intensify, but in a lower-profile manner than in recent years.”
>
> JEREMY SPIVEY / Cutting Edge Information

The biggest challenge for the industry will be learning how to create value in this new space. She suggests shifting the focus from changing the business model to changing the profit model.

“Pharmaceutical companies can’t make money the way they used to — which is bundling the cost of everything they know and do into the price of a pill — so the industry has to figure out how to make money differently,” Ms. Buck Luce says. “The intrinsic value is no longer in the pill alone, but rather, that the pill is part of a solution that improves health outcomes for the patient and for society.”

Because the Pharma 2.0 model is still working, company leaders will be hesitant to turn away from traditional practices and allocate resources — both money and intelligence — toward a new model.

“But it is important for senior leaders to build the new model while the old model is still generating cash,” Ms. Buck Luce says.

Innovative partnering with both traditional and nontraditional players is the key to succeeding in this new environment. Some companies have started experimenting with what EY calls “Phase 1 commercial trials.”

“Every week we see more examples of companies experimenting with ways to add information and insights to their product offerings to create solutions that address patient outcomes,” Ms. Buck Luce says.

Partnerships will play a big role in Pharma 3.0, and there will be much more collaboration with nontraditional, or even traditionally competitive, partners. An example of an innovative partnership between traditional players is ViiV, a global specialist HIV company established by GSK and Pfizer to deliver advances in treatment and care for people with HIV.

“Both companies believed that the world would be served better — as would they — by combining their respective assets to address HIV,” Ms. Buck Luce says. “Pfizer contributed its molecules and development resources, and GSK, which has older products and a strong commercial organization, contributed those to build the new company.”

She predicts there will be other types of partnerships between pharma and nontraditional players in the future, such as Microsoft, Google, Cisco, and food companies such as P&G and Nestle, and retailers like Wal-Mart, and infrastructure players such as FedEx and UPS.

Ms. Buck Luce says nontraditional players will get into the game because healthcare accounts for between 10% and 20% of many countries’ GDP, as well as up to 50% of some families’ budgets. There is a lot of money to be made in the health outcomes business and it will take innovative ideas to make this model work.

Nontraditional players will play a greater role because of their ability to deliver outcomes in the form of information, education, disease management, and monitoring.

One example of a nontraditional partnership is Bayer’s agreement with Nintendo. The two companies worked to create Bayer’s Didget glucose meter, which children can plug into their Nintendo DS players to monitor their blood-sugar levels.

Ms. Buck Luce stated that she and her colleagues are noting on a weekly basis new partnerships between a pharma or device company and an information services company or a technology company to create mobile apps that can help improve health outcomes.

“The future story of M&A is around innovative partnerships, where companies come together to leverage their different assets and attributes to move from a product to an outcome solution,” she says. “The new offering will demonstrate effectiveness in increasing outcomes around patient adherence, compliance, and engagement, and this will be the future of the industry.” PV

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Robin Robinson

Mergers CREATE Challenges

While mergers and acquisitions have been a long-standing strategy to fill pipelines, boost R&D, or flesh out capabilities, they can be a drain on productivity, revenues, and cultures.

Merging companies usually suffer some initial decline in revenue and productivity while the two companies are trying to reinvent the new company. Merging companies face many internal challenges: operational change management, a decline in productivity, shifts in staffing, a lack of company identity, and cultural integration. A successful merger requires a prompt integration with minimal disruption to customers and ongoing operations, says Claudius Wamlek, principal at Oliver Wyman's Delta business.

"To counteract earnings dilution due to goodwill write-offs, the acquiring company needs to either save costs or boost revenue," he says. "When a pharmaceutical company acquires one of its competitors, it usually does so by paying a higher price than what the target company's shares were worth on the stock market. This change of control premium, or goodwill, has to be expensed over the following years and reduces earnings."

M&A transactions tend to depress company earnings in the short run. At the same time, the merged companies become more financially robust with a reduced risk profile.

"The merged companies that are able to spread development and market risk over a greater portfolio of products can be expected to achieve above-market returns, if and when sales synergies materialize," Mr. Wamlek says.

Cultural Integration

According to a report by Oliver Wyman, Delta, Convergence, Not Compromise: The Importance of Pre-deal Alignment, most M&A failures stem from cultural issues: unreconciled differences among executives — in governance, strategic vision, management approach; little or no attempt at forging a common vision; and disparate ideas about fundamental ways of operating, from decision making to customer management philosophy.

At best — when both sides ostensibly support the merger — these issues can hamper integration, causing costly delays. At worst, they can sabotage the whole deal.

Another challenge in successfully integrating two different corporate cultures is getting complete buy-in on both sides, says Carolyn Buck Luce, global pharmaceutical sector leader, Ernst & Young.

Premerger Questions

When preparing to deal with the changes inherent in creating a new corporate culture, executive should ask themselves the following:

1. Do we, as members of the two executive teams, know from the outset how aligned we are — or aren't — in our vision, management philosophy, and operating models?
2. What do we know of our merger partner's culture and expectations?
3. Do we consider cultural understanding and convergence a necessary foundation for forging the key prerequisites of integration: strategy, governance structure, and a retention plan for key people?
4. What are we doing to understand the cultural commonalities and gaps?
5. Have we established a step-by- step process for defining the new company? Is it leadership, governance, etc.?

Source: Convergence, Not Compromise: The Importance of Pre-deal Alignment, Oliver Wyman Delta. For more information, visit oliverwyman.com.

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CAROLYN BUCK LUCE / Ernst & Young

" A successful merger requires a prompt integration with minimal disruption to customers and ongoing operations. "

CLAUDIUS WAMLEK / Oliver Wyman's Delta

"Culture eats strategy for lunch," she says. "Change management is not just communicating changes; it requires devotion and a focus on the people within the two businesses. The most innovative people will create the most innovative products and solutions, and this is the area that leaders need to focus on.

"A major acquisition is a real shock to the system," she continues. "It manifests a lot of uncertainty. Employees witness colleagues leaving and the ones who stay are also affected. Companies need to focus on communications that go beyond e-mail and Intranet announcements."

Ignoring the situation is a dangerous proposition and sure to lead to failure, according to the Oliver Wyman report, and the evidence is overwhelming: the speed of post-merger integration is critical to its success and to realizing the merger's promised value.

A way to lessen the shock waves of a major merger is to transcend the "us" versus "them" mindset and create a new corporate culture.

"While this is a difficult task by any standard, it is critical to the success of a merger, even before the deal closes and during the integration," Mr. Wamlek says. "

Oliver Wyman's Delta experts have observed that the longer companies delay convergence, the more time it will them take to integrate, and those that bypass or neglect the pre-deal convergence process usually have no idea just how much risk they are injecting into the merger.

When executives are asked about the success factors inherent in managing M&A transactions, cultural issues and operational synergies are often cited as critical — with cultural and organizational integration as the most difficult-to-surmount challenges of post-merger integration.

With this level of general awareness, it's hard to believe that executives involved in mergers are simply ignoring the cultural component. The problem is that most companies leave the cultural aspects of mergers to the post-merger integration phase; culture seems to be the most difficult issue to resolve, and there is no obvious candidate to lead the effort. Moreover, those driving the merger want to get to the finish line, and investors may purposely avoid probing any details about cultural differences that could break the deal. Yet, experts say waiting for the deal to close before addressing these issues is too late — it's a sure path to trouble or delay, if not outright failure.

Among the main obstacles along the way are legacy thinking and structures. One way to overcome these hurdles is to radically alter previous organizational structures. For example, when Roche bought Genentech, the U.S. operations headquarters were moved from New Jersey to South San Francisco, Calif., and operate under the Genentech name.

"Conducting a cultural diagnosis and thorough comparison of the DNA of each firm early on to define a new culture and monitoring the change post-merger are essential for long-term success," Mr. Wamlek says.

His suggestions for ensuring a smooth integration are to define a new strategic vision and corporate objectives with a clear roadmap on how to achieve these goals and communicate them throughout the post-merger process and show respect for the culture and achievements of the acquired company. PV

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Three Steps to Effective Merger Integration

Ernst & Young offers three tips to help companies implement a holistic and successful integration.

» Plans are nothing, planning is everything: Follow the wisdom of this quote from Dwight D. Eisenhower and spend a tremendous amount of time on planning. The planning process is critical. Companies need to have a plan in place for the 100 days before the merger and for the 100 days after. Even before the details of the merger are available, the companies need to engage in rigorous planning based on what needs to be done regarding systems, accounting, preparation of how to touch and inform customers, and how to prepare employees. Once the transaction is final, the company needs to quickly execute what needs to be done. When reality hits, the plan might have to be changed or altered, but the planning process will have helped you execute effectively.

» Plan vertically: At an enterprise level, the company needs to be thinking about the vertical planning around how the merger will affect the customer — from pricing, invoicing, communication, and accountability — all this has to be thought of across all business units and functions so there is a clear pathway to the customer that has been planned for as a new entity.

» Plan horizontally: Planning tends to happen vertically, where the focus is on what I am going to do in my business? The company also has to consider the horizontal planning around how the merger will affect its employees. A thorough examination of all the elements that will impact people, for example, the e-mail system, changes in benefits, and clarity around job descriptions, needs to be conducted and change management solutions put in place to address them. Companies also need to invest in change management plans in terms of getting new colleagues to meet each other, get to know each other, and learn how to work with each other.

Source: Ernst & Young. For more information, visit ey.com.