IMPROVING THE ODDS OF M&A SUCCESS in the Life-Sciences Industry

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Big pharma is at a pivotal point in its evolution. A recent report by PricewaterhouseCoopers suggests a shortage of promising products in the pipeline underlies many of the challenges faced by the life-sciences sector, including its deteriorating financial performance, increased sales and marketing expenditures, and negative press. The business reality is that the industry is spending twice as much on R&D as it was 10 years ago to produce fewer than half the new medicines it produced then. The basic research upon which drug discovery relies is becoming prohibitively expensive as academic institutions increase the valuation of their research and competition for these assets intensifies. The current financial climate, political trends, and quantum shifts in the way healthcare is delivered and measured are further creating pressure on companies to adapt and, ultimately, produce.

One readily accepted way to ramp up innovation in the life-sciences sector is literally to buy it. Despite a weakening economy, M&A advisory firm Berkery Noyes reports that 2008 was a solid year for mergers and acquisitions in pharma and healthcare IT, with transaction volume in the sector increasing by 16% compared with 2007. Private equity houses, historically disinterested in pharma, also have been getting in on the action. Small companies have limited cash, a fixed burn rate, and almost no access to capital right now because of the financial meltdown, creating a market opportunity for larger companies with the cash to sweep in and save the day.

It's a fairly common management insight, however, that most M&As are ultimately unsuccessful. Study after study has shown that most acquisitions fail to create value for the acquirers' shareholders; a BusinessWeek article on the subject suggested the best strategy for individual investors was to "sell as soon as they see a pair of CEOs approaching a podium."

Some recent industry statistics reveal:

- 75% of large mergers fail to create shareholder value greater than industry averages.
- Productivity drops 50% following the announcement of a merger.
- Leadership attrition soars to 47% within three years following a merger.
- Employee satisfaction drops 14% following mergers.
- 80% of employees feel senior management cares more about economics than about product quality or people.

Given this realization, why do so many companies still embark upon this precarious path? Is any M&A worth the risk? How can a company stack the odds in its favor?

WHY M&A?

Companies engage in M&A for many strategic reasons. In theory, shareholder value should always increase as a result, since maximizing shareholder value is the primary purpose of management. Most M&A discussions begin with legitimate business objectives and the genuine belief that the new "whole" will be greater than the "sum of the parts" and result in a market advantage for the new entity. It's expected that shareholders will be able to see the short-term benefits of a partnership and that long-term growth for shareholders, employees, customers, and business partners will result.

Common M&A themes include bids for increased market power, consolidation to facilitate economies of scale or scope through pooled resources, or broadening a geographic footprint. But players in the life-sciences sector are more often driven to join the M&A bandwagon by a need to bolster R&D productivity. "Stuffing the pipeline" is seen as the route by which a company can raise the odds that a successful new drug will emerge. Companies are further pressed by patent expirations: assuming an average patent period of 20 years and a drug discovery timeline of 15 years, the "harvest period" during which a drug can effectively be marketed is limited in many cases to about five years. Companies with promising late-stage pipelines are thus particularly attractive targets for M&A activity.

Dire predictions to the contrary, there is evidence to suggest post-M&A firms may yield higher profit margins than their pre-M&A entities, and M&A firms may fare better than their non-M&A rivals in ROI. Unfortunately, M&A activity may not always provide merging firms with the enhanced research productivity they seek. Experts postulate that problems encountered during the integration process, including management, cultural, and functional disconnects, ultimately take their toll on R&D. Glaxo's unconditional takeover of Wellcome, for example, resulted in a 400% increase in market capitalization in the four years following the merger. But the merged company has demonstrated a poor record of research productivity, as calculated by the ratio of new molecular entities (NMEs) to total R&D expenditures within a five-year time frame. Similarly, though the rationale behind the Pharmacia Upjohn merger was sound and its benefits ultimately realized, the initial merger was widely deemed a mess of uncoordinated management, unfocused product portfolios, and cultural disharmony.

So how can a company best navigate the M&A minefield?

FIRST THINGS FIRST

Success in M&A starts long before an opportunity is even on the table. The companies that prosper via M&A activity are those that have a demonstrated track record of success in growing their own businesses. This should be the first filter applied before embarking on M&A as a growth strategy.

Companies should be sure to question whether they've exhausted their organic growth opportunities before going down the M&A path. If an M&A approach is adopted, a cohesive portfolio of "smaller and smarter" strategic acquisitions and alliances — as opposed to the mega-merger — may be the way to go. For years Eli Lilly avoided M&A activity altogether, pursuing best-in-class products through heavy investment in R&D (19%-20% of sales vs. an industry average of 15%) and biotech partnerships. CEO John Lechleiter recently told the Financial Times he is not interested in a merger with Bristol-Myers Squibb, preferring to focus on improving Lilly's internal development and making smaller-scale buyouts. Similarly, Johnson & Johnson has achieved success via a host of strategic alliances with smaller players that complement its drug-discovery efforts.

FAILURE TO INTEGRATE

More often than not, though, M&A fails not in strategy but in execution. A failed integration of people, products, processes, and technologies between two entities ultimately means a failed merger.

Here are some common tactical pitfalls that can impact the success of any M&A venture:

- **Lack of prior M&A experience.** Companies that have failed to develop integration capabilities and resources risk "the panda effect," wherein infrequent mating results in clumsy execution and ultimately a fruitless outcome. Studies suggest that an implementation thus handicapped can cost hundreds of millions — perhaps even billions — of dollars in lost productivity and may even prevent the merged organization from executing its stated strategies.
- **Cultural clashes** between the two companies and their employees. Veteran integration managers agree that corporate culture affects all aspects of M&A success, from productivity and product quality to speed of integration and employee retention. Companies that fail to fully assess a partner's corporate culture before making an offer do so at great risk. A comprehensive plan for cultural integration must include regular, open communication with employees on both sides of the fence regarding integration activities and their effects on personnel.
- **Talent leakage.** Intellectual capital often walks out the door when acquisitions aren't handled carefully. If 100% of stock options vest, even happy managers may bolt as soon as their retention agreements expire.
- **Ineffective corporate governance** of the new entity.
- **Obsession over cost-cutting**, ultimately damaging the business by devaluing company personnel and other resources.
- **Lack of geographic proximity**, leading to communication obstacles and managerial inefficiencies.

For companies to overcome the odds and achieve M&A success, it's clear that two components are key: robust due diligence and a comprehensive integration plan. But what do those entail?

BEATING THE ODDS

Successful M&A requires a dedicated effort to discover opportunities and evaluate them both thoroughly and efficiently during the due diligence phase. Companies often engage investment bankers or other specialists for sourcing new M&A opportunities. Due diligence is typically handled in-house but may be augmented with outside advisors, depending upon the complexity of the deal. The Institute of Mergers, Acquisitions and Alliances (IMAA) cites J.P. Morgan and Goldman Sachs as the No. 1 financial advisors for pharmaceutical industry M&A in terms of number of deals and total known value, respectively; most-used legal advisors include Latham & Watkins and Skadden, Arps, Slate, Meagher & Flom.

As for the integration itself, experienced integrators establish experts and expertise long before M&A events occur, spending considerable time, effort, and resources to develop and employ detailed integration processes and procedures to mitigate the very risks discussed above. GE Capital, for example, uses a structured process called Pathfinder to guide participants through the integration cycle.

The Pathfinder model addresses the steps and issues that all companies should consider when undertaking M&A activity:

- **Pre-acquisition:** identify business and cultural barriers, select an integration manager, assess leadership strengths and weaknesses, develop a communication plan.
- **Foundation building:** orient new executives, jointly formulate integration plans, allocate resources, assign responsibilities.
- **Rapid integration:** conduct process mapping to accelerate integration, incorporate employee feedback, initiate short-term management exchanges between companies.
- **Assimilate:** continue to develop common tools and processes, continue long-term management exchanges, conduct integration audits.
- **Tools** such as checklists, timetables, templates, surveys, and automated project management systems can be used to enhance the planning and execution process, and existing resources in the form of process models, white papers, and the like can and should be tapped for guidance and support.

BRING ON THE EXPERTS

Companies often engage independent consultants to assist them in various phases of their M&A deals. The specific arrangements may take many forms, but generally companies look for consultants that have prior M&A experience and specific company, therapeutic, and/or functional expertise; and provide unbiased and neutral assessment and feedback; shorten the overall timeline; avoid management distraction; and/or help integrate the two entities and optimize the resulting operation.

Flexible human capital is becoming increasingly desirable to both knowledge-based workers and the companies that recognize their unique and timely talents. Effective knowledge retention is more critical than ever during periods of flux, so if a key manager abruptly departs during the process, an interim consultant might be hired to plug the gap. Further, few companies have the executive and managerial resources to manage their ongoing businesses while also undertaking M&A activity, so contract workers might be employed to keep day-to-day operations running smoothly while the flurry of M&A is taking place. The in-sourcing of project professionals can provide the expertise, responsiveness, cost-effectiveness, and resilience organizations need to survive during the relative instability of the M&A process.

Mergers and acquisitions can be risky, but smart executive teams in the life-sciences industry (and the boards they ultimately must answer to) can stack the odds in their favor by understanding the risks and the business climate in which they are undertaken; faithfully assessing their motives and strategies; following a rigorous, disciplined due diligence and integration process; and using the many resources at their disposal — ultimately enhancing the value provided by the newly merged company to shareholders, employees, and society alike. ✦

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