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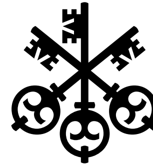

UBS

M&A: Using Uncertainty to Your Advantage

A Survey of European Companies' Merger and Acquisition Plans for 2012

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This report was prepared by The Boston Consulting Group on the basis of a survey of corporate executives in Europe conducted jointly with UBS Investment Bank.

December 2011

AT A GLANCE

This year's survey of top European executives by BCG and UBS Investment Bank finds that the desire for mergers and acquisitions persists in Europe as cash-rich corporations seek to grow their businesses and gain a competitive advantage.

WILLING BUT WAITING

As companies finish their housecleaning and as internal barriers to deal-making disappear, executives are increasingly willing to invest in M&A. But activity in 2012 will strongly depend on whether worries about the larger economy dissolve.

USE UNCERTAINTY TO YOUR ADVANTAGE

When operations stabilize and the impact of macroeconomic developments is understood, it will be time to move from focusing on risks to looking for opportunities. Investing in information will allow executives to act carefully but courageously while others remain paralyzed.

PHARMA: M&A AS A CURE (WHILE AVOIDING SIDE EFFECTS)

Mounting structural challenges and recent deals in the pharmaceutical industry demonstrate the strategic value of M&A. But uncertainty and deal complexity increase execution requirements for successful transactions.

Ducunt fata volentem, nolentem trahunt.
(Fate leads the willing soul, but drags along the unwilling one.) – Seneca

Despite stock market turmoil and worries about sovereign-debt crises that have rattled the euro zone, the region's corporations remain cautiously optimistic about the prospects for mergers and acquisitions (M&A) in 2012. Indeed, a number of indicators suggest that 2012 could be a good year for M&A if economic conditions improve. According to our fourth annual survey of the M&A plans of European companies, conducted together with UBS Investment Bank, companies continue to be optimistic about doing major deals next year. Market valuations in sectors ranging from financial institutions to energy look attractive. Cash piling up on the books of blue-chip European companies is at new record levels. And after spending several years getting their houses in order and honing their strategies in an environment of bewildering uncertainty, executives are once again ready to concentrate on growth.

But while the desire to acquire may be strong, the climate of risk and ambiguity could make it difficult to execute deals in 2012. This mixture of heightened internal optimism and external doubt showed up clearly in our survey. One in six companies is ready to make large-scale deals in 2012, for example. But some companies that last year were cautious are now even less likely to make a move owing to heightened unease over the macroeconomic environment.

Internal constraints to doing deals are declining, however, because many companies have cleaned up their operations. Even the willingness to invest has increased. Two-thirds of the companies we surveyed want to deploy their record stockpiles of cash to achieve growth, and a large share want to do so through M&A.

M&A deal-making in the midst of today's turbulent market is more difficult and requires skillful execution.

But M&A deal-making in the midst of today's turbulent market is more difficult and requires skillful execution. Success increasingly depends on the ability to assess risks and create value from complex deals that go beyond simple consolidation. When M&A works, however, it has the potential to overcome mounting challenges and substantially improve a company's competitive position. As is evident from our analysis of pharmaceutical companies, M&A is still regarded as a vital tool for addressing the urgent strategic issues confronting certain industries.

Will M&A activity remain flat in 2012, or will it shift into a higher or even a lower gear? How can executives adapt to the current environment and drive successful M&A? Much will depend on whether the macroeconomic picture becomes clearer.

After aggregating and dissecting the views of chief executives and senior managers from 148 of Europe's largest public companies, we find that a large number of companies are itching to pull the trigger as soon as the fog lifts.[1]

Navigating Lingering Uncertainty

For all the unsettling news that rattled markets through much of 2011, M&A activity was remarkably stable.

Companies making M&A transactions in 2012 will likely have to do so in a climate of continued macroeconomic doubt and in the face of multiple sources of risk. Three years after the onset of the global financial crisis, capital and raw-material markets show heightened volatility. Potential sovereign defaults in Europe threaten banks and the future of the euro. U.S. and European economic forecasts point to sluggish growth. These factors translate into very weak visibility for corporate earnings.

On top of the rocky economic environment, industry challenges are proliferating. Structural changes are occurring in response to government policy or political pressure, such as Germany's sudden decision to abandon nuclear power and calls in many countries for tougher regulation of financial institutions and health care providers. In industries such as automotive, pharmaceuticals, and chemicals, demand is steadily shifting to emerging markets that can be difficult to penetrate and that are producing their own aggressive corporate challengers.[2] Some industries are being redefined by new technologies or disruptive innovation. In many others, competition is intensifying, destabilizing market share and putting pressure on margins. Understanding the specific strategic challenges in an industry is key to successful M&A.

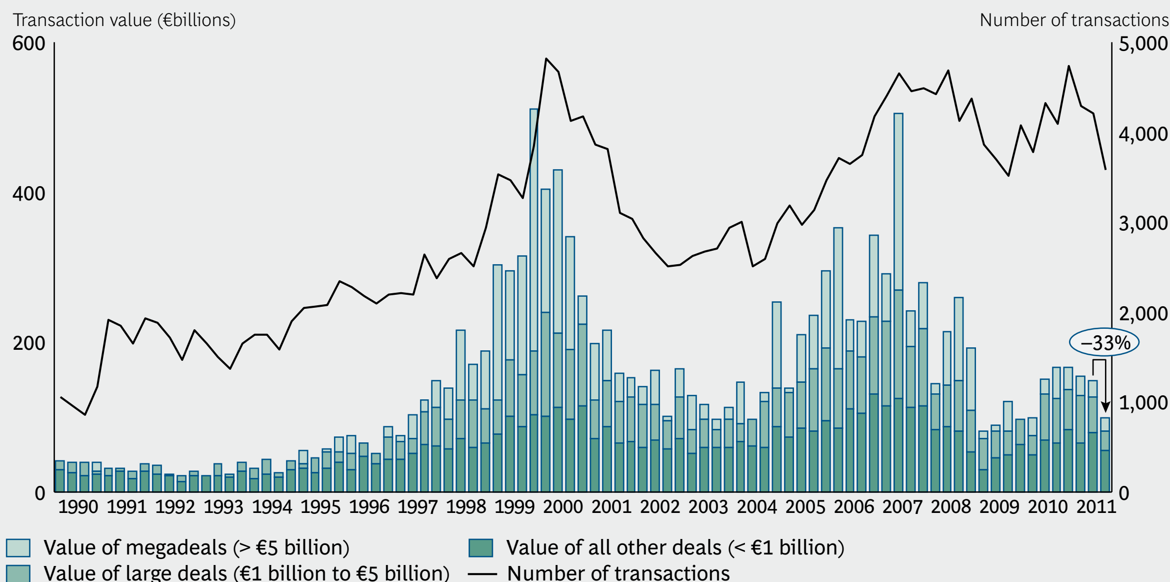
At the same time, capital is no longer reliably available to all companies. The market for initial public offerings has almost disappeared. Highly volatile stock prices make it difficult to price targets because neither acquirers nor targets want to be caught on the wrong end of a major market swing. As the sovereign-debt crisis develops, banks under pressure to increase regulatory capital are once again becoming very discerning about to whom they lend. Financing acquisitions could become even more difficult if European banks have to absorb further losses from sovereign-debt defaults.

Still, for all the unsettling news that rattled markets through much of 2011, M&A activity was remarkably stable. (See Exhibit 1.) The number of transactions remained high, at about 4,500 per quarter. Although transaction values were moderate, they too were stable for most of the year. By the third quarter, however, the impact of mounting fears over the financial crisis in Europe and the direction of the EU economy began to be felt. Deal values fell by 33 percent. Large deals—those valued at between €1 billion and €5 billion—plunged by almost 50 percent.

While executing deals in the midst of increased uncertainty is difficult, periods of structural disruption are actually favorable to M&A. In the current environment, financial deterioration is often due to the systematic decline of a company's competitive position rather than to a cyclical dip in demand. Generally a company's competitive position can be improved more quickly through M&A than through organic moves.

EXHIBIT 1 | European M&A Was Moderate in 2011 but Dampened After the Recent Correction

Value and number of announced European M&A transactions, first quarter, 1990, through third quarter, 2011



Sources: Thomson Reuters; BCG analysis.
Note: Includes all M&A transactions announced from January 1990 through September 2011 that involved either a European acquirer or a European target.

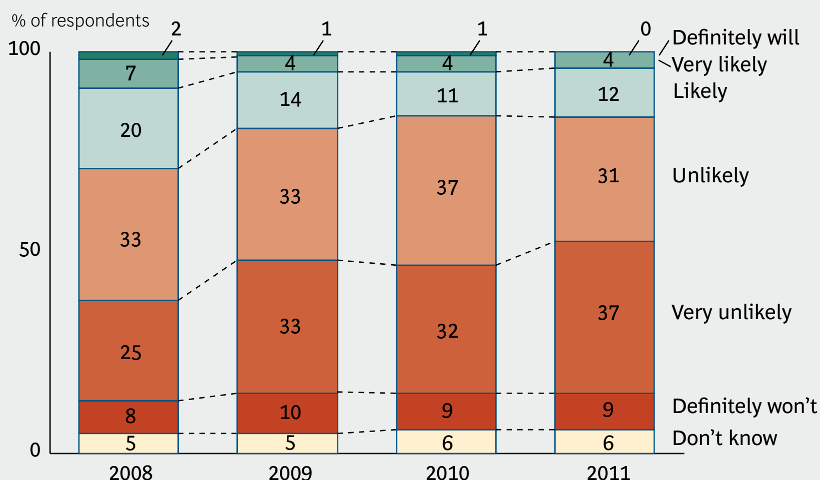
That said, it is likely that M&A deals in 2012 will have to be undertaken despite the low visibility of market conditions, company performance, and the impact of strategic moves, making sound analysis and execution all the more important. M&A is also likely to become more complex, especially as European companies focus on cross-border transactions or on weak targets in need of restructuring. This sense of necessity and opportunity mixed with caution was also evident in the responses of European companies to this year's survey.

Expectations for 2012: Willing but Waiting

As 2011 draws to a close, the expectations of European companies regarding M&A in 2012 closely resemble those at the end of last year. A stable share of companies are optimistic about deal making. As in last year's survey, one in six companies said it was likely to undertake large-scale acquisitions. (See Exhibit 2.) Among large corporations with sales of more than €15 billion, one-third are likely to do large deals.

Some industries show a particularly strong inclination toward M&A, namely financial institutions (34 percent likelihood), industrials (27 percent), and energy (23 percent). A small share of companies have become slightly more pessimistic, however, answering that they are "very unlikely" (rather than "unlikely") to do a major deal. Similarly, more executives this year than in 2010 (36 percent versus 31 percent) said they do not expect European public deals next year in their sector.

Exhibit 2 | Optimism Remained Steady in 2011, Although Pessimism Was More Pronounced



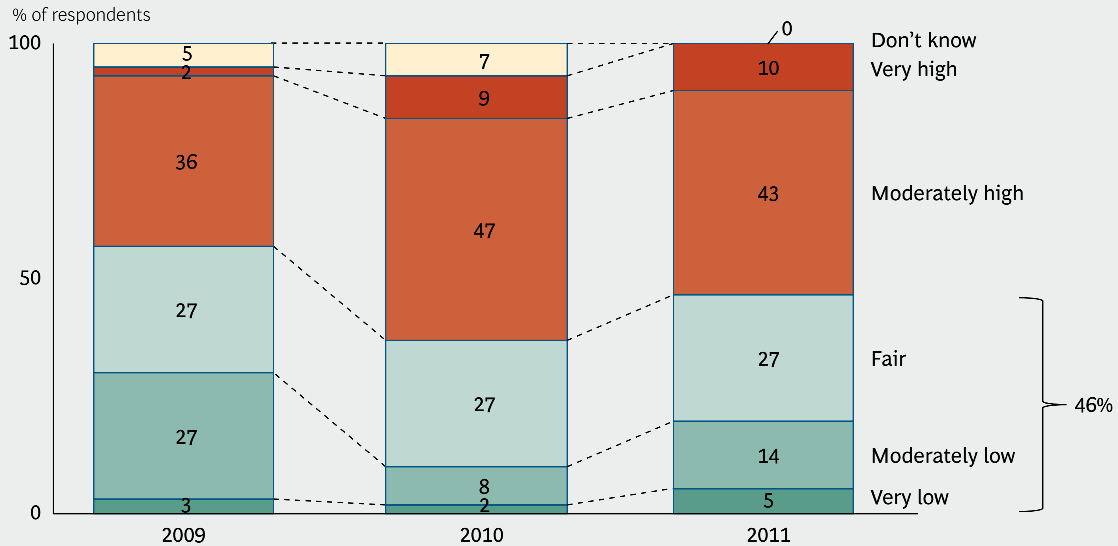
Source: UBS and BCG CEO/Senior Management M&A Survey, 2008, 2009, 2010, and 2011.
Note: Large-scale acquisitions are defined as those involving a target with sales of more than €500 million. Because of rounding, not all percentages add up to 100.

Continued optimism is strengthened by the perception that the prices of acquisition targets are attractive. Respondents who regard current price levels as fair or low jumped from 37 percent in 2010 to 46 percent this year. (See Exhibit 3.) Particular value is seen in telecommunications, where 75 percent see fair or low pricing, in financial institutions (72 percent), in energy (69 percent), and in health care (50 percent). Furthermore, a substantial number of respondents (38 percent) view 2012 as the ideal time to go ahead with a significant acquisition. But skepticism is somewhat on the rise. The share of executives who are unsure about the ideal timing nearly doubled, from 22 percent in 2010 to 41 percent this year. Surprisingly, recent stock-market turmoil has had virtually no influence on companies' appetite for M&A. Seventy-five percent of companies said the market correction had "no impact," while 12 percent said it had actually increased their appetite.

Internal Housecleaning Complete. This year's optimism is also driven by internal conditions that are much more favorable to M&A than they were in 2010. (See Exhibit 4.) Balance sheet and credit constraints have steadily declined as a perceived barrier to deals, from 29 percent in 2009 to 25 percent in 2010 to 20 percent this year. Investor concerns and lack of management capacity are regarded as only half as important as they were in 2010, with only 8 percent and 7 percent of companies, respectively, citing them as barriers. Similarly, companies seem to have essentially finished elaborating their internal strategies.

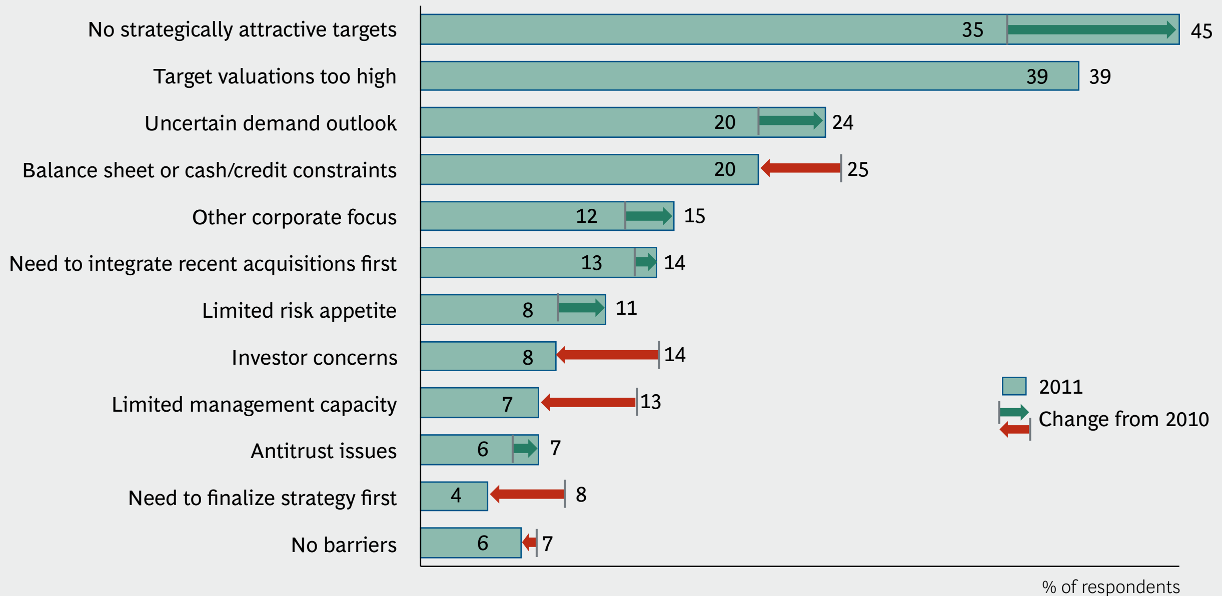
These signs of confidence are tempered by suspicions that the global economy may not be out of the woods in 2012. A lack of strategically attractive targets has become the chief barrier to M&A, with the number of companies citing that as an

Exhibit 3 | Perceived Price Levels Became More Attractive in 2011



Sources: UBS and BCG CEO/Senior Management M&A Survey, 2009, 2010, and 2011; BCG analysis.
Note: Because of rounding, not all percentages add up to 100.

Exhibit 4 | The Internal Conditions for M&A Have Improved, but External Barriers Have Increased



Sources: UBS and BCG CEO/Senior Management M&A Survey, 2010 and 2011; BCG analysis.
Note: The responses "Regulatory changes/concerns," "No targets that fit our acquisitions criteria," "Lack of pressure from competitors seeking same asset," and "Other" are not shown because of low frequency.

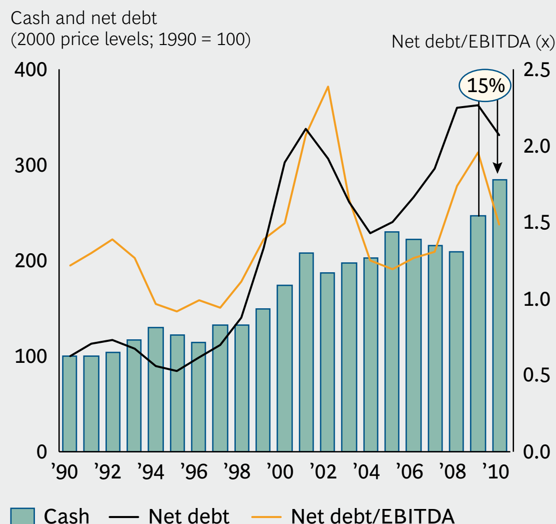
obstacle jumping from 35 percent in 2010 to 45 percent. Companies that cited an uncertain outlook rose from 20 percent to 24 percent, and those deterred by a limited appetite for risk increased from 8 percent to 11 percent.

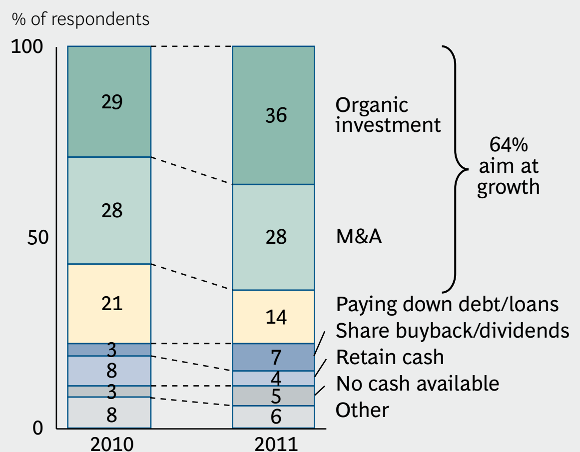
Unshaken Willingness to Make Deals. In last year's survey report, we noted that European companies had piled up record cash reserves that were ready to be deployed for growth. That is even more true this year. (See Exhibit 5.) Cash levels have risen by another 15 percent, and most of the increase is available for investment, as reflected in net debt levels and net-debt-to-EBITDA ratios. Although companies showed a high willingness to invest in 2010, the mounting cash indicates that executives retained considerably more money than intended. This is also reflected in the moderate M&A values noted above.

This year, European executives are even more impatient to put their cash to productive use. Those citing growth moves as the most effective use of cash climbed from 57 percent to 64 percent—another sign that companies have completed their internal housecleaning. Unaffected by the recent stock-market turmoil, 28 percent want to invest their cash in M&A, the same proportion as last year.

While barriers to M&A have changed significantly since last year, the drivers have not. (See Exhibit 6.) The most commonly cited motives for M&A in 2012 again relate to growth: new products (55 percent), expansion into new regions (36 percent), and access to new customers (32 percent). The growth focus is shifting, however. While new products and new customers are declining as rationales for M&A, access to new regions is on the rise. The importance of increasing profitability

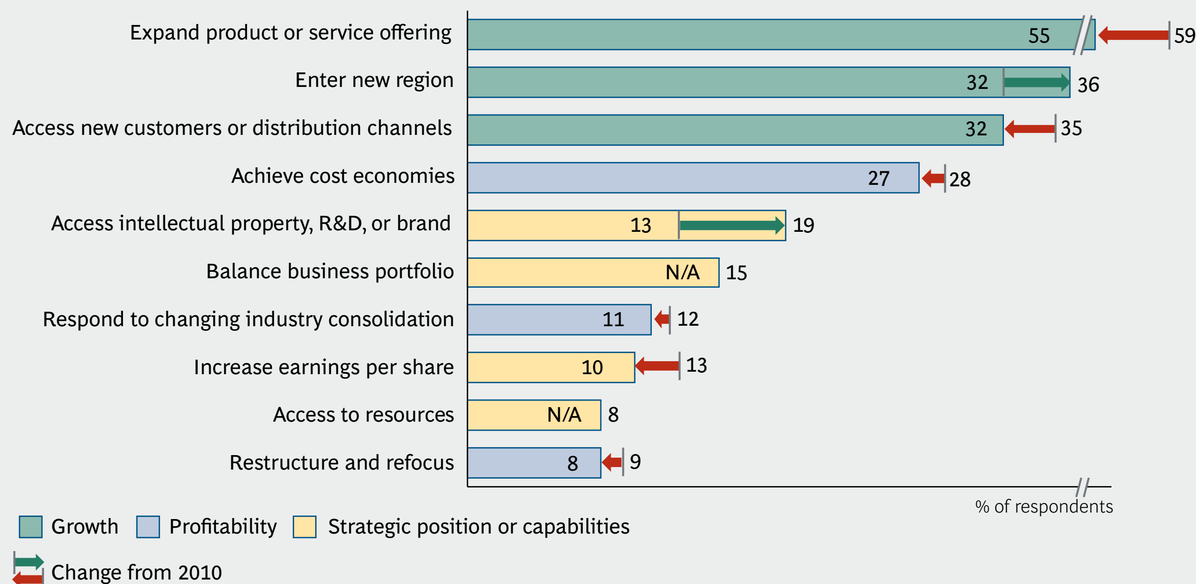
EXHIBIT 5 | Companies Continue to Pile Up Cash and Are Increasingly Ready to Use It





Sources: Thomson Reuters Datastream; UBS and BCG CEO/Senior Management M&A Survey, 2010 and 2011; BCG analysis.
Note: The left-hand graph is based on 257 nonfinancial companies in the current Stoxx Europe 600 index that reported cash figures throughout the period shown.

EXHIBIT 6 | Growth Continues to Be High on Executives' M&A Agenda



Sources: UBS and BCG CEO/Senior Management M&A Survey, 2010 and 2011; BCG analysis.
Note: The responses "Access to human capital," "Offset increased supplier and customer power," "Preempt predator acquisition," and "Other" are not shown because of low frequency.

and improving the company's capabilities or strategic position remains similar to last year.

Deal-based restructuring also remains high on the agenda, with 30 percent of executives saying that such moves are likely for their company in 2012. Next year will probably see a large number of asset disposals to strategic investors, which 64 percent regard as the most attractive route. This is not surprising. Recent regulatory tightening in the banking industry has lowered the funding available to financial investors, and opportunities for initial public offerings are limited in today's fluctuating capital markets.

Emerging Markets Gaining Relevance. When focusing on geographic growth, more and more companies look to emerging markets. In 2010, only 16 percent of the European companies surveyed named cross-continental acquisitions in emerging markets as "most relevant." This year, that number jumped to around 28 percent. By contrast, those viewing intra-European deals as key dropped by six percentage points, to 27 percent. The shift to emerging markets is hardly surprising. The global economy increasingly resembles a two-speed world, comprising the relatively stagnant industrialized nations and such rapidly growing economies as Brazil, Russia, India, and China.[3]

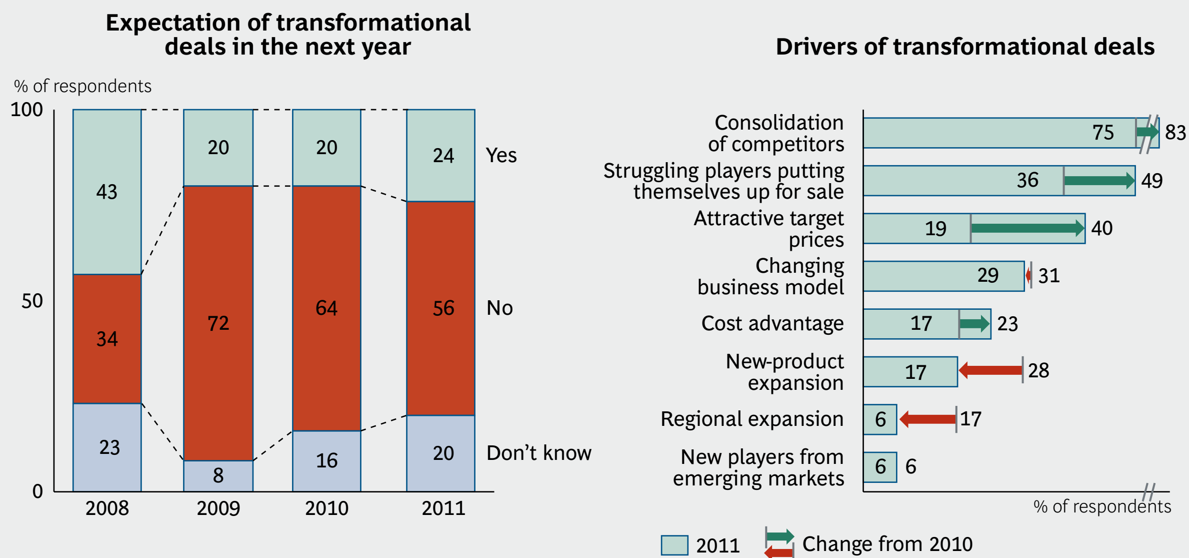
Home Turf Transformation. While in many industries the potential for future growth is clearly in emerging markets, most European companies must still act to

transform their strong but challenged position in the slow-growth West. Transformational deals, therefore, are gaining in importance, with 24 percent of companies expecting such deals in their industry in 2012 (up four percentage points from last year) and only 56 percent not expecting them, compared with 64 percent last year. (See Exhibit 7.) Financial objectives are gaining in importance in transformational deals, with the number of executives citing consolidation as a driver rising from 75 percent to 83 percent. Other leading drivers of such deals are "struggling competitors putting themselves up for sale" (cited by 49 percent of respondents, compared with 36 percent in 2010) and "attractive target prices" (40 percent, up from only 19 percent last year). The search for cost advantage is also a growing motive, cited by 23 percent of respondents.

Although the focus on financial improvement—rather than growth—in transformational deals may seem to contradict our earlier findings, in fact it does not. Executives do assign great strategic importance to growth, especially in emerging markets. But such opportunities are long term and are not yet large enough to dramatically improve competitive position. Instead, companies must achieve transformation primarily by addressing the financials of the bulk of their business, which is on their stagnant home turf.

Prepared Companies Favored by Uncertainty. In 2011, many companies cleaned up their internal affairs. In 2012, M&A activity will strongly depend on how the macroeconomic climate evolves. If current worries dissolve, we expect that companies will move ahead, and 2012 will be a strong year for M&A—at least in the second half, since deal volume would likely take some time to pick up. If worries do not abate, we expect next year to be very difficult.

EXHIBIT 7 | Transformational Deals Are Reviving as a Means of Improving Financials



Sources: UBS and BCG CEO/Senior Management M&A Survey, 2008, 2009, 2010, and 2011; BCG analysis.
Note: The response "Securing raw material access" is not shown because of low frequency.

We believe that the results of our survey series—and of this year's survey in particular—indicate that we have entered a new normal for M&A. Uncertainty is here to stay. Visibility will remain murky. Large waves of M&A deals across all industries will be unlikely, because everyone is contending with the same macroeconomic barriers. As opportunities arise, we will see spikes in deal volume driven by daring but far-sighted executives intent on improving their companies' competitive position. Because they will have spent time doing their homework, they will be armed with superior information and will be able to act when the window of opportunity opens. While the majority of companies will remain frozen by uncertainty, the strong and prepared will reap the benefits of M&A and catapult ahead.

Use Uncertainty to Your Advantage

Last year, we argued that companies should make friends with uncertainty. We believe that this year, more companies are starting to realize that uncertainty is not likely to be a temporary phenomenon. Executives should take the next step and use it to their advantage. For at least the next year, success in M&A will largely hinge on the ability to execute opportunistic deals in uncertain times. We offer three guidelines in the art of using uncertainty to your advantage.

Companies should spend more time and effort screening M&A opportunities. Prices and conditions can change quickly, and the window of opportunity may open only briefly.

Change the focus from risk to opportunity. Understanding and quantifying risks—and developing contingency plans for when bets go awry—will obviously be essential. But risk and opportunity generally go hand in hand. When internal housecleaning is complete, it is important to start looking for pearls in muddy waters. Structural shakeups can open up valuable opportunities to enter new markets or to buy assets at attractive prices.

Companies should spend more time and effort—not less—systematically screening M&A opportunities. Prices and conditions can change quickly, and the window of opportunity may open only briefly. Clearly identifying potential targets and their strategic fit well in advance will enable companies to act quickly when opportunities arise.

Mental flexibility is also important. Because visibility is weak and conditions are fluid, solutions to strategic challenges may lie beyond the trodden path. Acquirers should look twice at assets that are of mixed quality, for example. These may offer great value at attractive prices that can be extracted in unconventional ways. Taking out redundant costs is not the only way to create value through M&A.

Buyers and sellers should also consider creative deal structures, such as risk-sharing arrangements or deals that include payment or financing options. These can alleviate concerns about uncertainty and risk.

Invest more in information. Solid information is most valuable when times are uncertain. Greater due diligence is required to minimize risks—and improve the chances of success. Companies in the market for deals in 2012 should spend more time and resources understanding market dynamics, their own strategic challenges and position, and their potential moves. They should sharpen their grasp of the true boundaries of their markets and the universe of available targets. Solid infor-

mation can increase their chances of finding convincing opportunities that their competitors fail to identify.

Developing a clear story to justify a deal is necessary in order to convince skeptical investors and employees. Similar principles apply to asset divestitures. A clearly articulated equity story can maximize the prices paid. For a troubled asset, a convincing restructuring concept and early implementation of first steps can substantially increase its market value.

Take energizing but careful action. Acting with solid but still incomplete information requires courage. But taking decisive, careful action while others remain paralyzed wins respect in the capital markets and among staff seeking guidance in difficult times—and this can release the energy needed to transform an organization.

Taking decisive, careful action while others remain paralyzed wins respect in the capital markets and among staff—and this can release the energy needed to transform an organization.

If a company is optimistic, it can leverage the crisis to gain a competitive advantage by investing countercyclically. If the environment seems too murky for big moves, small investments in tangible business opportunities can put a company in a position to ramp up in promising new areas once external factors improve. Companies should hedge their bets by acquiring minority stakes, making investments that secure a foothold in new markets, and investing in stages or through cooperation agreements.

To be able to invest, companies must make financial provisions. External funding constraints are likely to linger next year. The flexibility to mobilize funds internally, therefore, can offer a significant competitive edge. Companies looking for acquisitions should prepare by building an internal financial cushion so they can act when others can't.

The M&A environment in 2012 will remain challenging. Therefore, executives should start coming to terms with uncertainty and adapt their strategic approach. By understanding the specifics of the current situation, they can use it to their advantage—and move ahead of the competition.

Pharmaceuticals: Using M&A as a Cure (While Avoiding Side Effects)

Given the acute pressures faced by biopharmaceutical companies that originate innovative drugs, this industry provides a good illustration of why skillfully executing the right kind of M&A can spell the difference between emerging from the current uncertainty in a weaker or a stronger competitive position. Below, we provide a brief overview of the industry's challenges and M&A options, based on our strategic insights into the industry and our functional expertise in M&A, followed by specific recommendations for biopharmaceutical companies regarding M&A. Our analysis focuses on drug originators rather than on producers of generic or over-the-counter drugs, although some of the same challenges and solutions apply to them as well.

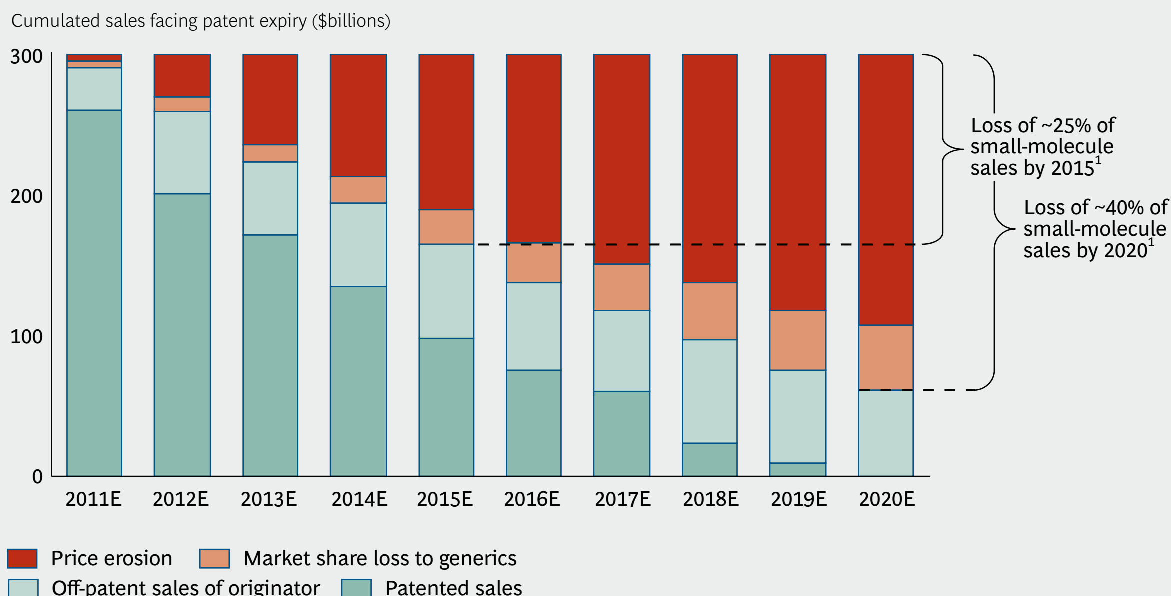
Facing pressure from all sides, the pharmaceutical industry is one of the likeliest to generate a high degree of M&A activity. A confluence of four major strategic chal-

lenges makes the prospects grim for large drug originators: the so-called patent cliff, rising pricing pressures, the faltering R&D-driven business model, and the growing importance of emerging markets.

Falling Off the Patent Cliff. Over the next five to ten years, many of today's top-selling drugs will lose their patent protection, especially the small-molecule drugs that dominate the product portfolios of major originators. For many of these companies, revenues in the near future will fall steeply as prices plunge and cheaper generic versions grab market share. We estimate that originators' sales from currently marketed small-molecule drugs will drop by about 40 percent by 2020 due to patent expirations, with almost two-thirds of this loss occurring in the next five years. (See Exhibit 8.) Not all originators will be hit equally. Pfizer, for example, with the expiration of just one patent—for the cholesterol-lowering drug Lipitor in November 2011—faces a potential loss of up to $11 billion in revenue, or 15 percent of its sales. As a result, the company is expected to lose its number-one market position in terms of sales to Sanofi. Because of the patent cliff, many pharmaceutical companies face enormous pressure to slash their large fixed costs or to refill their product pipelines.

Price Premium Pressures. Further revenue losses are being induced by pressure on price premiums for innovative drugs from governments and payers trying to rein in soaring health-care costs. Prices for new drugs are increasingly tied to clear evidence of incremental benefit over the next-best drug available. Other price-

Exhibit 8 | About 40 Percent of Originators' Sales of Small-Molecule Drugs Will Be Lost Through Patent Expiry by 2020



Sources: Evaluate Pharma; IMS; Datamonitor; BCG analysis.
Note: Off-patent originator sales reduced by price erosion rates (separate for the U.S. and EU) and market share loss to generics players; no sales growth assumed.
[1]Small-molecule sales in 2010 calculated from IMS market size and Evaluate Pharma originator share.

control mechanisms imposed by health care providers that depress the revenues and margins of both new and existing drugs include price caps, mandatory discounts, and reference price systems.

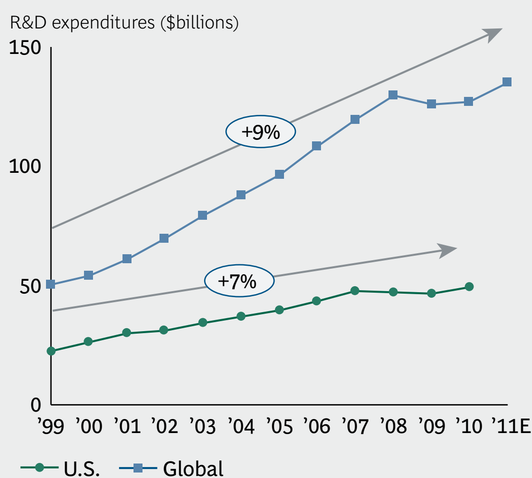
A Faltering Innovation Model. The basis of originators' business model—creating innovative drugs—is also being fundamentally challenged. While global R&D costs have risen by an average of 9 percent annually since 1999, the payoff has not increased. The number of new-drug approvals per year has remained essentially flat for more than a decade. (See Exhibit 9.) The reason for this decline in R&D productivity is that achieving breakthrough innovation with chemically synthesized drugs, still the dominant technology among many originators, is becoming more difficult. Small-molecule drugs for many diseases already exist, and further advances tend to be incremental. In addition, regulators are tightening approval requirements, making it harder to bring new products to market. The search for breakthrough therapies that address important unmet needs, such as chronic and degenerative diseases like cancer and HIV, is frequently driven from the field of biologics, where many originators are not yet as strong as in small molecules.

The problem becomes especially evident when we look at the number of hugely profitable blockbuster drugs in the market. (See Exhibit 10.) While this number rose by an average of 13 percent each year from 2000 through 2010, it is expected to remain flat over the next five years.

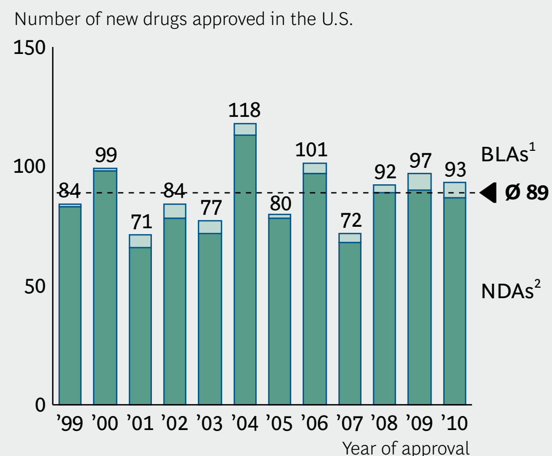
The Emerging-Market Imperative. Most originators are facing a mismatch between their geographic exposure and product portfolio, on the one hand, and

Exhibit 9 | Pharma R&D Productivity Is Essentially Flat

Historically rising R&D expenditures...

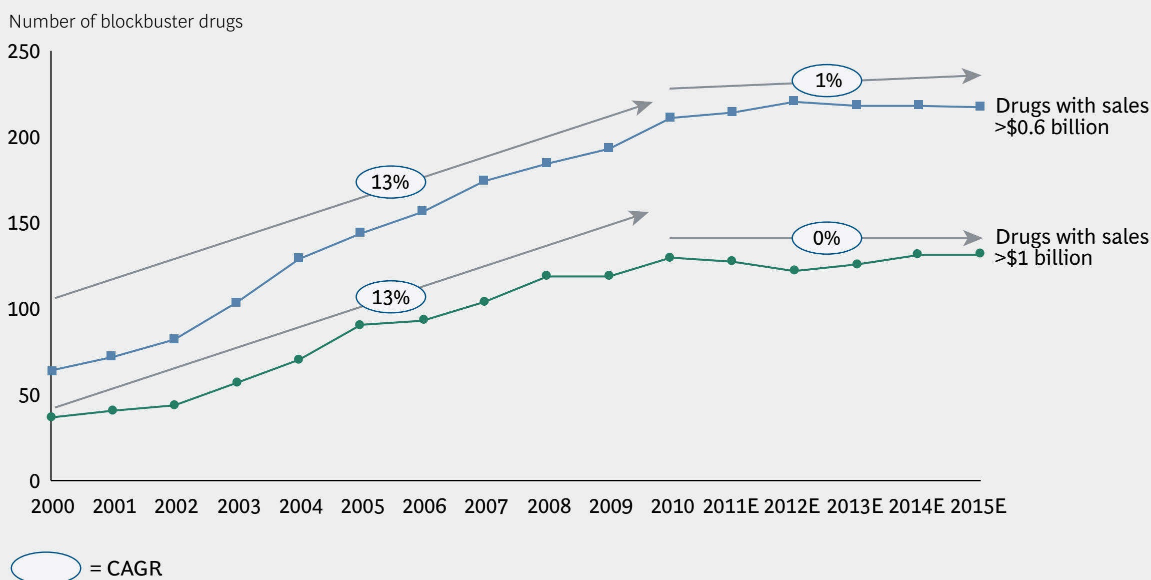


...have not increased the market entry of drugs



Sources: FDA; PhRMA, "Pharmaceutical Industry Profile 2011"; Evaluate Pharma; BCG analysis.
[1]BLAs = biological license applications.
[2]NDAs = new-drug applications.

Exhibit 10 | The Number of Profitable Blockbuster Drugs Is Flattening Out



Sources: Evaluate Pharma; BCG analysis.

their market opportunities, on the other. As a result of the patent cliff, price pressure, and a stuttering innovation engine, their core markets in the developed world are expected to stagnate in the years ahead. Growth will come from emerging markets with large and expanding populations, developing health-care systems, rising wealth, and a growing incidence of lifestyle diseases such as diabetes. Pharmaceutical sales are projected to grow by an average of 14 percent per year in key emerging markets through 2015. In contrast, 5 percent average annual growth is expected in Japan and virtually none in North America and Europe.

Yet Western originators still have a relatively limited presence in the "pharmerging" regions, and these drug markets remain small. As a result, emerging markets will not easily compensate for stagnating revenue in the West, at least in the short term. What's more, the product portfolios of many originators are frequently not well suited to emerging economies, where demand is still focused on basic, low-cost generic and over-the-counter medications. Selling product portfolios that are heavily dominated by innovative drugs at high premiums, therefore, is a challenge. In addition, originators' focus on innovation makes it difficult to establish the rock-bottom cost structures often necessary to succeed in emerging markets.

Biopharmaceutical companies can, of course, expand into the growing segments of biologics and generics. But these businesses can only partially compensate for losses in the short term. Margins in the generics industry, for example, are themselves under pressure from the clampdown in health care spending and from competition that is even stiffer than that for patented drugs. Finally, operating a low-cost business model in parallel with one driven by innovation is generally difficult for originators because of the differences in governance, corporate culture, and strategic focus.

Dissecting Pharmaceutical M&A Moves

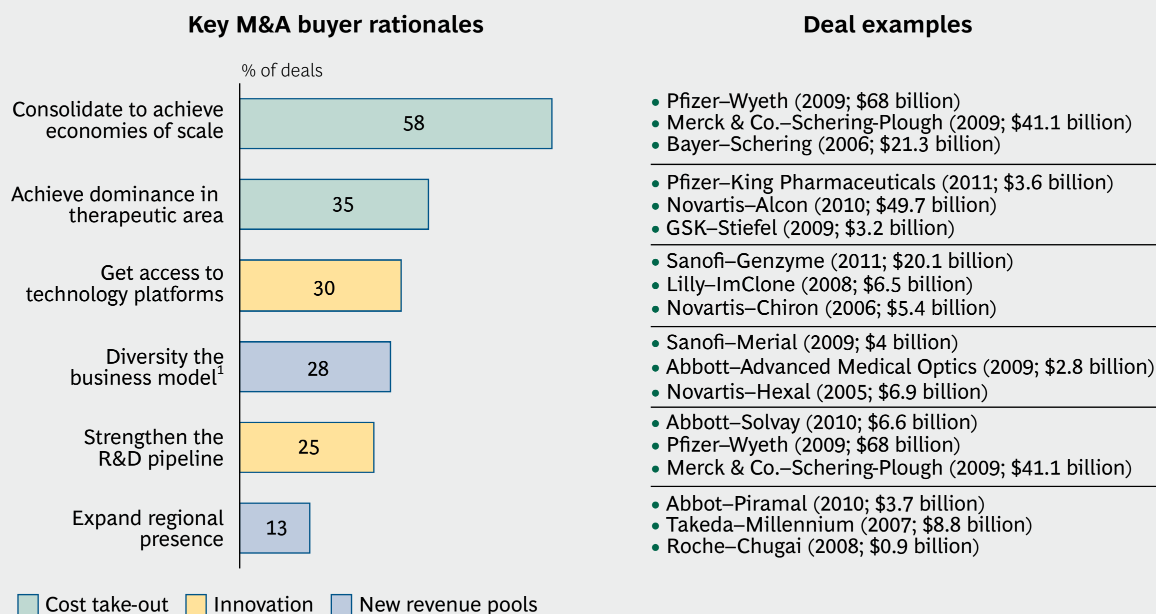
The patent cliff. Price pressures. The faltering innovation model. Underexposure to growing market segments. Strategic challenges are hitting pharmaceutical companies from all sides, strangling growth prospects and margins. While organic changes are therefore a necessity for most biopharmaceutical companies, the extent of the challenges make M&A an increasingly necessary part of the strategic response as well.

To understand the many ways in which pharmaceutical companies are using M&A to respond, we analyzed the 80 largest pharmaceutical M&A transactions since 2005.[4] (See Exhibit 11.) We found that the companies that did these deals had some combination of three basic goals: maintaining margins in an environment of price pressure, bolstering the innovation pipeline, and adding new revenue pools to strengthen top-line growth.

Maintaining Margins. In most large deals (58 percent), the major objective was to slash costs through pure consolidation. By combining sales forces, manufacturing, and overhead with those of another company, originators strive to eliminate redundant costs—and to spread R&D investment and the associated risks over a larger revenue base. For example, Pfizer's 2009 acquisition of Wyeth, which followed its 2003 takeover of Pharmacia, enabled it to build greater scale and secure its position as the world's largest pharmaceutical company.

Around 35 percent of deals aimed at improving margins by building dominance in a specific therapeutic area. In so doing, companies increased their negotiating

EXHIBIT 11 | The Majority of Pharma M&A Deals Aim to Take Out Costs



Sources: Evaluate Pharma; company information; BCG analysis.
Note: Based on the 80 largest deals closed between 2005 and 2011.
[1]Diversification into generic and over-the-counter drugs, medical technology, and diagnostics.

power with health care providers and regulators and leveraged their sales forces, R&D capability, and knowledge of patient needs in a given area. In the future, a dominant position in a therapeutic area will also allow companies to extend their business model beyond the provision of drugs to the offer of holistic treatment programs. Novartis's $49.7 billion acquisition of Alcon in 2010 enabled it to strengthen its presence in the growing eye-care segment, for example.

Bolstering Innovation. It is not surprising that addressing the innovation challenge is the most urgent priority after maintaining margins, since R&D is integral to originators' business model. Thirty percent of big M&A deals sought to bolster innovation by giving the company access to new technology platforms. Biotech companies are a major target of small-molecule-dominated originators seeking more sustainable growth. The biotech industry is growing much faster (8 percent per year over the next five years) than the small-molecule segment (2 percent) because it still offers greater potential for breakthrough innovations that can command high premiums. While biologics face their own patent cliff, it is often less steep because these especially complex drugs and their production processes are more difficult and costly to copy, which limits competition from generics. Revenues from biologics are therefore more sustainable.

Addressing the innovation challenge is the most urgent priority for originators after maintaining margins, since R&D is integral to their business model.

Twenty-five percent of large deals—in addition to a large number of smaller deals—are aimed at strengthening the R&D pipeline with drugs in the early or late stage of development. There is considerable debate in the industry about whether acquisitions are the best way to expand the portfolio of new-drug candidates. One attraction of going to outside sources rather than relying on internal R&D is that the company can essentially turn fixed R&D costs into variable costs. Another is lower risk, since much of the cost of failure is shifted to the outside partners. Moreover, pharmaceutical companies cherish the entrepreneurial spirit that is often pronounced in start-ups. On the other hand, spotting and securing the most promising targets ahead of the competition is difficult, and the deal premiums paid for companies with successful R&D can be stiff. This can depress returns on external R&D investments.

New Revenue Pools. The intensifying search for new avenues of growth beyond established markets was reflected in many of the large pharma M&A deals that we studied. Diversifying into fields adjacent to classic prescription drugs was an objective in 28 percent of these deals. Diversification into over-the-counter drugs, diagnostics, or medical technology can help reduce risks by easing a company's dependence on patented drugs and by helping it achieve a more balanced mix of businesses and cash flows. For example, Abbott's acquisition of the surgical-device company Advanced Medical Optics for $2.8 billion in 2009 allowed it to diversify into the fast-growing eye-care device market.

In general, many companies in the diagnostic and medtech segments are still posting attractive growth because they address unmet patient needs, achieve relatively high levels of innovation, and face fewer regulatory challenges. By marketing drugs along with diagnostic and medtech products through product bundling or personalized medicine, originators can often add value and charge higher prices. In ophthalmology, for example, several players offer drugs, surgical instruments,

and implantable lenses together. However, establishing a good governance model and go-to-market approach for such a combination of diverse businesses is not easy.

Thirteen percent of transactions were aimed at expanding the company's presence in strategically important emerging markets. Such acquisitions are generally driven by the search for market access, distribution power, local market know-how, and a suitable portfolio of low-cost products. Abbott, for example, acquired the generic-drug business of India's Piramal Healthcare for $3.7 billion in 2010. These deals are especially challenging because of the complexities of cross-border transactions.[5]

Favorable Conditions, but Solid Execution Required

Despite current market volatility, pharmaceutical companies' M&A activity should seek to address the challenges described above while also taking advantage of favorable external conditions. M&A activity in the sector has remained strong in recent years, so there is ongoing momentum. Major drug companies have substantial financial firepower: lots of excess cash, low debt levels, and cash flows from current blockbusters that are still strong. Debt financing is still available to high-quality strategic corporate buyers, including pharmaceutical companies. And there are many potential targets. The industry is still highly fragmented, with numerous start-ups and emerging biotech and medtech companies in need of new funding sources in the current environment. Antitrust issues are generally not serious.

The market prices of potential targets have dropped, especially since the recent stock-market correction. The current low valuation multiples of most pharmaceutical companies partly reflect the industry's structural challenges, inducing many executives to regard potential targets as still too expensive. But others regard this as overly pessimistic. A UBS analysis of global pharmaceutical companies' current market valuations concluded that they may actually be significantly undervalued relative to their fundamental cash flows. The analysis shows that current valuations assume a 12 percent yearly decline of free cash flow between 2013 and 2020—an outlook that even the most pessimistic industry managers do not share.

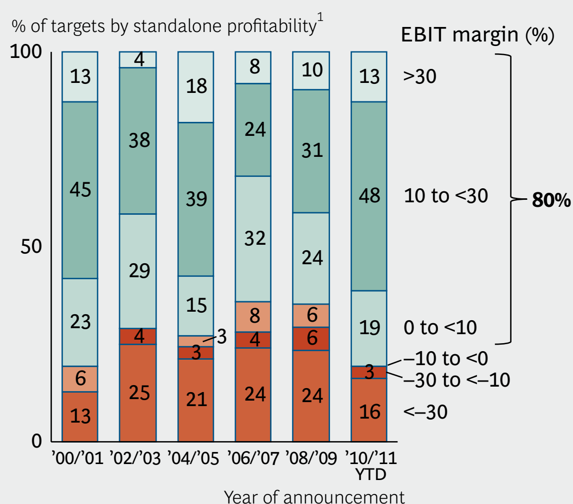
M&A activity in the pharmaceutical sector has remained strong in recent years, so there is ongoing momentum, and major drug companies have substantial financial firepower.

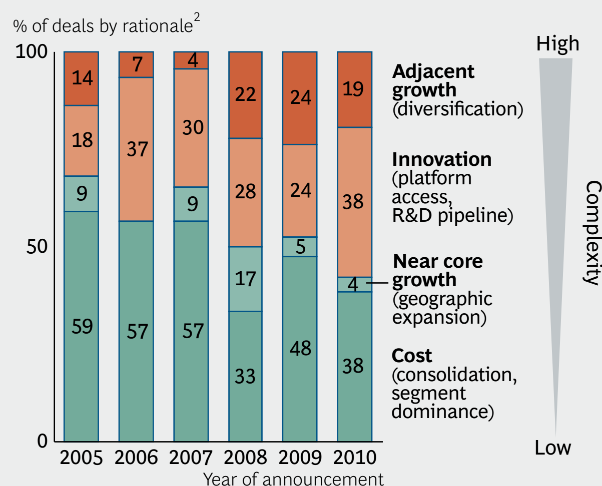
Complex Value Creation. Many pharmaceutical executives tell us that the pool of attractive assets is dwindling and that those remaining are of mixed quality. Competition for the remaining high-quality targets is intense, driving up prices and making value creation increasingly difficult.

But the belief that asset quality—if measured by profitability—is deteriorating may be off-base. Our analysis of pharmaceutical acquisitions over the past decade does not indicate a downward trend in the profitability of acquired assets. (See the left-hand graph in Exhibit 12.) About 80 percent of acquired targets are profitable, a proportion that has remained roughly constant since 2001. It is true, however, that our analysis looked only at transacted assets, which could be of better quality than those generally available for sale.

Good assets are regularly becoming available as pharmaceutical companies divest well-performing businesses that are not an optimal fit with the parent portfolio and

Exhibit 12 | Operational Fit Is Getting More Difficult to Achieve





Sources: Thomson ONE; Evaluate Pharma; BCG analysis.
[1]EBIT margins of the targets of global pharmaceutical deals worth more than $100 million.
[2]Based on the 80 largest deals closed between 2005 and 2011.

that could perform better under different ownership. For example, AstraZeneca sold Astra Tech, its dental technology, urology-device, and surgical-device business, to Dentsply for $1.8 billion in June 2011. Pfizer is exploring strategic options for its nutrition and animal-health businesses, which it believes have limited synergies with its core human-biopharmaceutical businesses.

Pharma executives are right, though, that fit and the creation of operational value from deals are increasingly difficult. As the focus of M&A shifts from simply consolidating and taking out costs to expanding R&D platforms and fostering adjacent growth, integration and synergies become much more difficult to achieve. (See the right-hand graph in Exhibit 12.)

Extracting revenues from innovation-oriented deals and achieving operational synergies across assets not directly related to the core business are tricky endeavors that often require building new competencies. Deals in which pharmaceutical companies aim to diversify into medtech illustrate how complicated value creation can be. On paper, synergies are often sought by leveraging sales forces or by developing and selling combination therapies. However, many hurdles must be overcome to make this work. Sales forces must learn to sell these combined products, very different R&D departments must cooperate closely, and executives of the combined drug and device business must learn to manage two very different operations. Indeed, Abbott recently announced that it will break up its pharmaceutical and medtech businesses into two independent companies, which it believes can perform better on their own.

Rigorous Execution Requirements. Given that M&A is increasingly necessary—though extracting value is more difficult than it was in the past—what should pharmaceutical companies do?

Companies must go beyond looking only for problem-free assets with products that fit perfectly into their existing operations.

First, they must be more thorough than ever in searching for attractive targets, determining the optimal fit, and delivering on the promised synergies. To get all this right under the time pressure of completing a deal requires that companies develop clearly defined hypotheses that can be validated early on, instead of waiting until the due diligence process to look for opportunities to create value. Complex opportunities for value creation require that the value proposition, the integration model, and the governance model be clearly defined well ahead of the transaction.

Second, pharmaceutical companies must go beyond looking only for problem-free assets with products that fit perfectly into their existing operations. The key to successful M&A is finding assets that offer more value than is currently reflected in their price. Viewed this way, many complex assets—such as those with issues limited to one area or whose future is uncertain—might make attractive targets if the acquirer is skilled at turning around troubled assets and the deal is structured accordingly.

Sanofi's $20 billion acquisition of Genzyme in February 2011 is a good illustration. When Sanofi was negotiating the deal, there was considerable disagreement about the value of Genzyme's product pipeline and the company's ability to resolve its severe manufacturing problems. To get past the disagreements, Sanofi made Genzyme shareholders a creative offer. In addition to the cash price offered for Genzyme shares, Sanofi offered a tradable option known as a contingent value right (CVR). The CVR could pay up to an additional 20 percent of the purchase price contingent on the achievement of milestones in resolving the manufacturing problems and developing Lemtrada, Genzyme's experimental multiple-sclerosis drug. Although the uncertainties could not be resolved, this innovative option structure made the deal successful.

Third, deals involving innovation require special execution. While often necessary to complement the organic R&D pipeline, these deals are especially challenging from a governance perspective. Tightening the reins on an acquired R&D team can strangle innovation and prompt researchers to flee the new bureaucracy. Too little control, on the other hand, can result in R&D cost overruns. Finding the right balance is essential. Solving governance questions is also a key challenge in diversification deals. It can be successfully addressed through meticulous up-front planning and experience in integrating and organizing such business models. Still, diversification almost always requires company-specific solutions; there is no one-size-fits-all governance or go-to-market model.

In general, the degree to which a company relies on external innovation should depend on the competencies available. An originator needs to be strong either in building entrepreneurship internally and fostering organic innovation or in screening M&A deals and building an external pipeline. In any case, building one competence or the other is required.

Fourth, as pharmaceutical M&A continues to grow more complex, acquirers' communications with investors and employees need to be very clear. The deal's rationale should unambiguously address one or more of the industry's core challenges that relate to value creation. Clear messages on synergies require a good understanding of the future relationship between the target and the acquirer—and they need to spell out exactly where the added value will come from.

The good old days of simply consolidating businesses and taking out costs are certainly over in the pharmaceutical industry. Yet in today's environment, where M&A is one of the key ways to tackle strategic market challenges, the ability to do the right deals the right way will give companies an even clearer competitive edge.

NOTES

1. The BCG-UBS M&A survey was carried out between October 3 and November 9, 2011, and polled 701 publicly listed European companies across 28 industries; it had a 21 percent response rate.

2. See *The 2011 BCG Global Challengers: Companies on the Move—Rising Stars from Rapidly Developing Economies Are Reshaping Global Industries,* BCG report, January 2011.

3. For a more detailed discussion, see *Collateral Damage, Part 8: Preparing for a Two-Speed World—Accelerating Out of the Great Recession,* BCG White Paper, January 2010.

4. We excluded licensing deals from further analysis and focused on general (and often strategically more significant) M&A transactions. For a discussion of licensing in pharma, see Simon Goodall and Dirk Calcoen, *Biopharma Partnering: Perspectives from BCG's Latest Biotech and Pharma Partnering Study,* BCG, March 2011.

5. See *Cross-Border PMI: Understanding and Overcoming the Challenges,* BCG Focus, May 2010.

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12/11