BARBARA MICKELSON

Get Ready to Merge or Diverge

IN A VOLATILE MARKETPLACE, EVERY PHARMA COMPANY MUST BE PREPARED TO KEEP UP WITH THE M&A FLOW.

Patrick Kager and Jan J. Malek

Pharma mergers have hardly brought runaway success. Yet, judging from industry CEOs' public pronouncements, on the horizon is another merger and acquisition wave that will challenge both participants and spectators. The M&A game of the future may diverge drastically from strategies of the past, as multiple acquirers begin to target specific therapeutic franchises rather than whole companies.

Companies that take the merger route will have to handle a gamut of issues, from selecting the right partner—espe-

Patrick Kager (pkager@dc.com) is a partner and **Jan J. Malek** (jamalek@dc.com) is a senior manager in Deloitte Consulting's life science practice in Boston.

cially as the number of attractive prospects diminishes—to persuading increasingly skeptical financial markets of the transactions' value and wringing real benefits from them.

Those that decide to remain independent will face a different set of challenges. They will need to remain competitive with merged rivals that have expanded product portfolios and increased marketing and R&D budgets. To avoid being caught by surprise, they will also have to decide how long they can afford to sit on the sidelines. (See "Pay Attention," page 54.) Will they take the leap if their relative size and ranking fall below a certain threshold? Will they counter if one of their R&D or marketing partners becomes a takeover target? Will they jump in if the opportunity to break up a company and acquire an attractive therapeutic franchise presents itself?

This article describes how M&A activity in the pharma industry is likely to unfold during the next five years, examines the underlying rationale for that activity, reviews the financial performance of past deals, and poses a novel approach to pharma M&As, regardless of current attitudes toward them.

Urge to Merge

The pharmaceutical industry has consistently displayed one of the lowest levels of market concentration of any major industry. But that is changing. The market share of the largest pharma company doubled from Merck's 4 percent share in 1994 to GlaxoSmithKline's 8 percent today. And the combined share of the top ten pharma companies has increased by 40 percent. According to Deloitte Consulting's analysis, that trend will continue, and the combined market share of the top five pharma companies could easily increase by 85 percent, from the current 22 percent to 40 percent by 2005. That is likely to occur through five to ten major transactions during the next five years as the top ten pharma companies race to solidify their positions and snatch up the remaining attractive acquisition targets. Those transactions will be based on the following criteria:

- the extent to which product lines and R&D pipelines complement each other
- strategic intent
- sustainability of going it alone
- cultural compatibility
- R&D or marketing partnerships and alliances
- organizational structures—functional versus business units
- geographic proximity.

Those factors have the greatest impact on the success of mergers and their effect on value creation—or destruction. Companies that fail to use them to evaluate potential acquisition targets and merger partners do so at their peril. (See "Where It Goes Wrong.")

Apart from company rivalry, what is the economic rationale for pharma mergers and acquisitions? The most frequently cited sources of value include

- expanded product portfolio and replacement of products whose patents have expired
- increased scale of R&D in the face of new scientific developments
- increased size of sales forces, leading to increased sales
- elimination of overlapping manufacturing and administrative functions.

Although analysis suggests that none of those arguments is particularly persuasive, it is worthwhile to review the evidence for and against them.

Product portfolio expansion. Adding to the argument for this classic strategy, the merged entity will amass a fuller portfolio of leading products across a larger number of therapeutic categories, enabling it to increase its penetration of managed care formularies. In that case, the merger would create tangible financial value for shareholders. But analysis

WHERE IT GOES WRONG

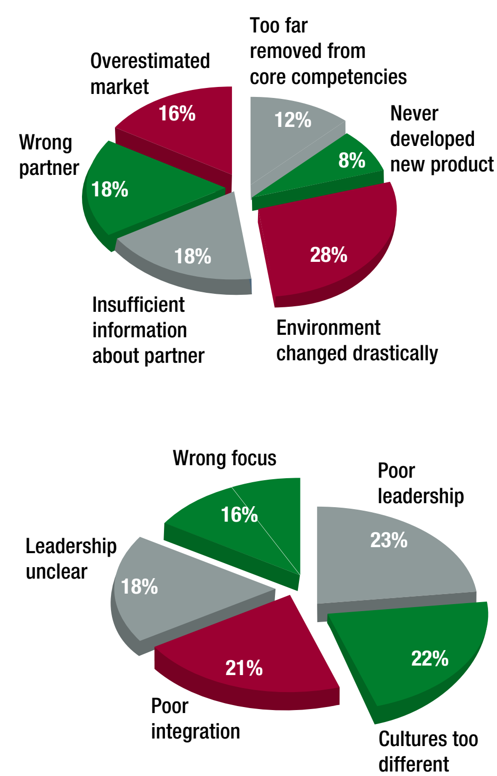
Failure to capture M&A value can be traced back to approach, execution, or both.

Failure in Approach

It seemed like a good idea but it wasn't.
These failures occur primarily during the strategy and targeting phases of the process.

Failure in Execution

The idea was good, but it didn't work.
In this case, the transaction was never successfully put into operation.



Source: Deloitte Consulting

PE Graphic

shows that few pharma company transactions during the last decade have increased the market share of the combined entities. (See "The Billion-Dollar Pyramid," *PE*, August 2000.)

R&D productivity and scale. Analysis of the relationship between pharma R&D expenditures and the number of new molecular entities or regulatory filings fails to confirm the presence of economies of scale, regardless of time period. So there is no reason to believe that the increased size resulting from combined R&D groups will magically increase productivity. In fact, a merger could reduce R&D productivity if it increases the operation's complexity, which is almost inevitable if the combined company ends up with more R&D locations. Historically, pharma companies have been reluctant to move or consolidate R&D locations because they fear losing valuable and hard-to-find talent.

But it is possible that the overall scale of R&D activity required to gain access to the full panoply of industry technologies and the concomitant investment requirements have increased as a result of new scientific advances. That would support the value of spreading the costs and risks of those technology investments over a larger base—a bigger R&D budget or aggregate revenues—thus favoring mergers. That the benefits of those new advances have yet to translate into increased R&D productivity or effectiveness supports that theory.

Sales force. Pharmaceutical sales forces have grown significantly during the last decade. The combined United States–based sales force of the top 40 pharma companies has more than doubled, from 38,000 sales reps in 1996 to 80,000 in 2000. Given that increase, it is questionable whether further sales force expansion will result in sales increases, especially considering that most physicians are too busy to see reps in the first place. In fact, the number of sales calls has increased at a fraction of the growth rate of rep employment, seriously raising doubts about the benefits gained from combining sales forces.

Cost reductions. When well executed, mergers create opportunities to cut administrative costs and to consolidate manufacturing. But the sheer magnitude of a transaction is an insufficient reason to justify doing it, and pharma companies have unimpressive track records for maximizing a merger's value.

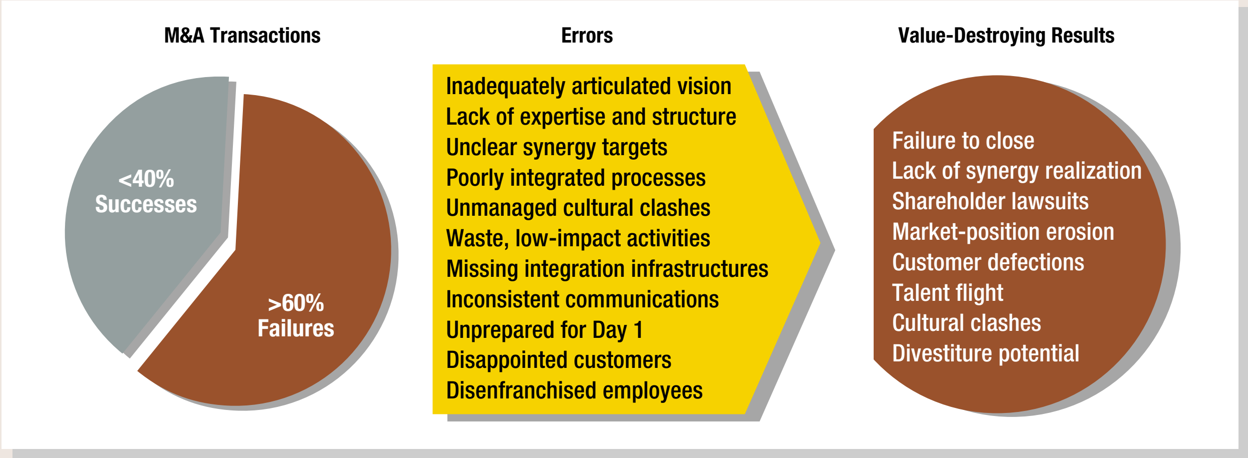
Catching onto that trend, Wall Street has begun to take a less sanguine view of pharma M&As. Whereas earlier deals enjoyed an immediate rise in market capitalization, the financial markets reacted negatively to the three most recent mergers, reducing the combined valuations of the participating companies by 10–20 percent. The message seems to be that investors are unwilling to give management the benefit of the doubt at the time of announcement, so management must persuade the markets that it has a solid plan for creating value through the transaction.

In evaluating transactions and communicating with financial markets, pharma companies need to recognize that the accounting rules for M&A transactions in the United States have changed. The "pooling of interest" method of merger accounting, in which the acquired company's value is based on depreciated cost rather than market price, is now dead. Companies will be required to use the "purchase" method, under which the difference between market and book values is designated as an increase to the book value of acquired tangible assets, in-process research and development, intangible assets, and goodwill—which can make up as much as 60 percent of the pharma purchase price.

The new accounting rules' earnings-per-share implications are less favorable than the "pooling" approach but less onerous than the old purchase accounting, which required annual amortization of all goodwill and intangible assets. The new rules require intangible assets with a finite useful life to be amortized. They also subject goodwill and intangible assets with an indefinite life to an annual

PAY ATTENTION

Errors arising from management's lack of attention to the merger process lead to failures.



Source: Deloitte Consulting

PE Graphic

By the time a company realizes that it needs to get involved in a deal, it is too late to prepare.

impairment test that requires assets' book value to be reduced from cost to fair market value.

Most important, the new rules require that acquisitions be allocated to the reporting units of the acquirers that benefit from the transaction. Although none of those changes will affect cash flow and should not get in the way of transactions with a persuasive value-creation rationale, management must ensure that it clearly communicates that rationale to shareholders and financial markets.

New Directions

As pharma market share becomes more concentrated, the M&A game itself may change. So far, pharma mergers and acquisitions have entailed the combination of entire companies and, at times, have fallen apart as a result of therapeutic overlaps and FTC mandates. But that is not always the case in other industries. Frequently, acquirers keep some pieces—such as divisions or product lines—and dispose of or spin off those that don't fit their strategy.

Although that has not happened in the pharmaceutical industry to date, as therapeutic franchise (TF) overlaps rise along with market concentration, companies will have to seriously consider two new options: splitting targets up-front with a joint bid from multiple companies or spinning off some TFs as separate companies after the transaction's close. A pharma company is the sum of different TFs, from discovery to sales and marketing, and it is certainly possible to separate their franchises and recombine them with acquirers' franchises.

Splitting up a company along TFs may be difficult, but it is usually feasible. The most complex issues would occur in the areas of manufacturing, pilot plants, and possibly some discovery labs, because they are most likely to support the entire company rather than be dedicated to specific areas.

The key issue, as in all M&As, will be how the people who created the target's value are treated. If treated well, there is no *a priori* reason to believe that they would object to the company being split along TF lines any more than they would object to other types of mergers. In fact, a highly attractive TF may make a better target than the whole company, because integrating a single TF—in which the acquirer presumably had little, if any, presence—requires significantly less effort than integrating an entire company with multiple TFs. The real complexity lies in executing the deal: analyzing the target, valuing the TFs, finding co-acquirers, negotiating the contract, and ensuring that the target's people do not walk out the door.

Be Prepared

Even if a company is not planning to participate in a transaction, it must achieve a minimum level of M&A preparedness for two reasons: First, preparation has the greatest positive impact on M&A success; and second, the timing and likelihood of participating in a merger or acquisition is unpredictable. By the time a company realizes that it needs to get involved, it is too late to prepare. That will increase along with the advent of break-up acquisitions in which the opportunity to join a "deal in the making" may be fleeting.

Deloitte Consulting's research shows that companies can significantly improve the probability of success by preparing. Conversely, lack of preparation plays a significant role in M&A failures, whether they occur in strategy or execution. (See "Lessons Learned.")

M&A activity often comes as a surprise, not only to the organization at large but also to CEOs, CFOs, and directors. The Pfizer/Warner-Lambert transaction is a poignant reminder that the future holds unexpected turns. In May 1999, Pfizer's CEO William Steere stated, "I see no need to merge with another drug manufacturer." Six months later, Pfizer filed papers with the US Securities and Exchange Commission to take over Warner-Lambert. That experience is not unusual. Out of six pharma companies that publicly professed in 1998–1999 to have no interest in M&As, four have since concluded such transactions.

But there is danger in waiting until the last minute to become involved in the game. Spoilers—the Pfizers and General Electrics of the world—must act quickly,

Lessons Learned

The following tactics should be part of companies' M&A preparations:

- Establish an acquisition strategy that focuses on the sources of value.
- Determine the maximum price before making a bid.
- Conduct thorough financial, legal, and commercial due diligence.
- Clearly quantify revenue and cost synergies.

Tips for M&A execution:

- Aim for a quick integration. Speed matters.
- Focus integration on clearly defined value drivers.
- Address retention issues early and often.
- Launch small, rapid, iterative integration teams.
- Align organizational roles and responsibilities and communicate them effectively.
- Consider the importance of culture. Humanize the merger.
- Clearly and frequently communicate to stakeholders the implications and progress of the merger.

and because they are limited in the due diligence they can conduct, they may overpay in the heat of the battle.

A less dramatic but nonetheless important issue is making plans for participating in M&A activity in the course of daily business. When a transaction materializes, advanced planning can yield significant benefits. To quote the controller of a large pharma company, "If we had thought about the potential for a merger even six months ago, we would have saved considerable time and cost now."

In contrast to frequent acquirers like GE and Cisco, which have honed their approaches through many years of transactions, pharma companies do not engage in M&A activities often enough to develop the discipline and skills needed to ensure success. Yet M&A victories are largely the result of preparation, practice, and experience.

History shows that, although there are always many unexpected twists and turns, companies can greatly improve their chances of M&A success by engaging in the following set of targeted activities:

- Survey the marketplace, analyze competitors, study M&A successes and failures, develop likely industry acquisition scenarios, and identify suitable targets as well as potential suitors.
- Develop a formal M&A process with defined roles and responsibilities.
- Train the management team to execute transactions and manage the postmerger integration.
- Identify the skills and capabilities that the company lacks and will be unable to develop. Identify external parties—bankers, lawyers, and consultants—who can assist in those areas temporarily.
- Manage the culture and prepare the organization for the possibility that it may engage in M&A activities at some future date. Given the uncertainty that staff and middle managers experience during mergers and acquisitions, senior management must truthfully communicate its philosophy for handling post-transaction activities.
- Identify impacts on IT infrastructure and plan future investments to become M&A ready.

Create Lasting Value

To realize M&A benefits, companies must have an explicit understanding of the benefits they desire, a defined mechanism for securing them, a premeditated and disciplined implementation approach, and reliable tools for tracking progress. Wringing benefits from a merger does not happen automatically. As a veteran CEO who has completed multiple acquisitions ruefully concludes, "Buying is easy, merging is hell." Ensuring M&A success requires consummate preparation, meticulous implementation, and constant vigilance.

A successful merger is the end result of a long and arduous process, during which companies must engage in considerable and highly detailed planning long before the close. Those activities fall into three time frames: pretransaction, transaction close, and postclose integration. (See "Merger Timeline," page 60.)

Merger integration is a full-time job and must be recognized as such, or the deal is destined for failure.

Pretransaction. To manage the postmerger integration process, the combining companies must create a program management office to coordinate all merger-related activities, to appoint executives who will be responsible for the process, and to define their roles and responsibilities.

The second major task during this period is identifying and planning activities and projects necessary to execute the merger and to ensure the anticipated benefits are realized. It is critical to clearly define the areas that must be addressed in the short term and those that can be delayed for a year or two. This is also the time when the acquirer or combining organizations will determine the pace of the integration for each area, including R&D, manufacturing, sales and marketing, and corporate functions.

The third key activity is preparation for Day 1—the day the merger is consummated. While all those activities are taking place, the two merging organizations must continue to conduct their day-to-day business as two separate and independent entities. For that reason, senior management must recognize that managers can be responsible for running their daily businesses or for managing integration—but not for both. Merger integration is a full-time job and must be recognized as such or the deal is destined for disaster.

Communication and project execution. The second phase of the merger process focuses on planning and executing Day 1 activities in detail. It also initiates the process that brings the combining entities together, including the deployment of synergy-creating initia-

MERGER TIMELINE

Detailed planning for the three basic merger phases is essential to laying a foundation for M&A success.

Announcement, Preclose → Transaction Close, Postclose Integration →

Countdown	-270 to -30 days	-30 to +90 days	+90 to +730 days
Communications	**Program Planning and Project Definition**	**Communication and Project Execution**	**Manage, Evaluate, and Reallocate**
Operating Transition	• Focus on organizational structures • Identify and prioritize projects to support integration objectives	• Commence project execution and Day 1 communications • Focus on a platform for future growth, synergy capture	• Focus on delivering project objectives and capturing synergies • Reallocate resources and create/ redefine projects as necessary
Synergy	Two companies acting as two companies	Two companies acting as one company	One company

Merger Organizational Design
- Create program management office
- Define and establish leadership roles
- Define and establish team structure
- Define integration roles and responsibilities for both companies

Project Management
- Define projects by function/business
  - Optimal IT solution
  - Define process work-arounds
- Conduct risk reviews, project prioritization and reprioritization, etc.
- Develop process and tools to manage and track project planning
- Project approval

Day 1 Preparation
- Develop projects and communications for consummation of merger (Day 1)
  - Communication plan
  - Establish plan for employee consolidation and facility rationalization

Day 1 Communication and Execution
- Develop process and tools for managing Day 1 activities
- Execute Day 1 communications

Project Execution and Synergy Capture
- Develop process and tools to manage and track project execution
- Conduct program level project reviews, reprioritize projects
- Synergy review
- Rationalize facilities

Creation of New Company
- Execute employee consolidation plan
- Establish new roles and responsibilities
- Begin creation of new company

Project Evaluation and Synergy Capture
- Develop process and tools to evaluate projects and reallocate resources
- Complete facilities rationalization
- Close out projects and shift to function/business

New Company Definition Complete
- Implement system infrastructure
  - IT migration/system infrastructure
- Implement work processes throughout new company

Platform for Growth
- Build new business infrastructure
- Integrate technologies
- Install strategic investment projects

Source: Deloitte Consulting

PE Graphic

tives and progress tracking. During this phase, the two merging companies begin to act as one.

Postclose integration. The third phase, which starts about 90 days after the close and lasts one to two years, focuses on building synergies and developing the new, combined organization. Throughout the entire process, from pretransaction through postmerger integration, communications with internal and external stakeholders and management activities focused on the transition are key.

Managers may easily overlook some of the many activities that take place throughout the merger process, inviting them to return to haunt the new company. One frequently overlooked issue is the need to create tools that standardize the budgets and financial reports of the combining companies. That is especially difficult if they have two different organizational structures, such as functional and divisional. Creating a consistent set of budgets is resource intensive but essential if managers are to run their businesses efficiently and meet demanding postmerger targets.

A set of tools that companies often overlook tracks the participants' success at achieving synergies after the deal's close. By preventing the combining companies' managers from playing games or creating fictitious M&A benefits, such tools ensure that reported synergies translate into improved cash flow or increased earnings. A good example of such game playing is when employees whose jobs are eliminated immediately return as long-term contractors—because the work still has to get done—pocketing hefty separation bonuses on their way out. Such mistakes can occur when finance keeps track of payroll and permanent headcount but not contractors.

The pharmaceutical industry will continue to experience M&A activity for the next five years. To access financing, companies will need to persuade investors that they can buck the trend of past M&A failures and deliver real value, a proposition that requires a clear vision, careful preparation, and disciplined implementation. And, if they want to be ready for the future, all companies, regardless of their current plans and attitudes toward the consolidation trend, must develop M&A–readiness plans. ∎