Perspective

The Latest In Tech, Pharma And Device M&A

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Published May 8, 2014

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Introduction: Are Megadeals Returning?

From telecoms, to energy, to pharma to orthopedics, corporations have accelerated their interest in megadeals that have the potential to disrupt their respective industries.

Over the past several months, the following transactions have been announced:

- Comcast Corporation's $45 billion takeover of Time Warner Cable Inc.
- General Electric Co.'s interest in buying Alstom SA's energy business for more than $12 billion
- Pfizer's interest in acquiring AstraZeneca PLC – in a deal that could be valued at more than $106 billion
- Zimmer's proposed acquisition of Biomet for $13.35 billion

According to the Wall Street Journal (WSJ), corporate executives have been emboldened by rising stock prices and recovering economies in the US and Europe. The WSJ suggested that following the financial crisis of 2008-2009 – and less-than-stellar results from some past megadeals – company executives lost their appetite for "big M&A" and instead hoarded cash. Confidence has now returned to Boardrooms – driven by microeconomic factors, escalating stock prices and opportunities like variations in international tax rates making merging into foreign companies financially attractive.

Dealogic reported through April 28th of 2014:

- 14 deals or bids worth at least $10 billion have been announced – the most since 2007. And, those figures don't include the proposed Pfizer and Zimmer deals;
- Announced deals of less than $500 million accounted for only 21% of volume (based on dollar value) – the lowest amount for this period of time in Dealogic's records;
- Primarily due to a more robust US stock market, 18% of announced M&A – as measured by dollar volume – were stock-only deals. Cash-only deals (by dollar volume) fell to 48%, the lowest percentage since 2001. (Note: The all-stock trend is

particularly pronounced on tech deals, where the acquirer seeks to retain top talent by offering stock in the combined company); and

- The bulk of activity has been in the pharmaceutical sector which accounted for 13% of the total global M&A activity – behind only telecoms, media and technology

Keep in mind, however, the megadeal trend can quickly subside, especially if markets turn, economies worsen or tax policy changes. Historically, deal activity picks up – only to sputter again.

What's Driving Pharmaceutical-Specific M&A?

Pharma dealmakers suggest recent transactions are being driven by a combination of market pressures, the increasing complexity and cost of drug development and the enduring hangover from patent expirations.

The WSJ proposed that pharmaceutical companies are "finding cash-squeezed governments and private health plans often won't pay the high prices of new medicines unless the drugs provide a big lift to patients. The tight-fistedness comes at the very time when companies need new revenues to replace aging products, but the science required to find difference-making new medicines has become more complex and specialized".

What's Behind Pfizer's Pursuit of AstraZeneca – And Pfizer's "Inversion" Strategy?

According to pharma industry experts, Pfizer "is shifting from its steady diet of cost-cutting and reorganizations over the past few years…….and shedding non-core businesses like animal health while trying to build up businesses in specific categories". In essence, Pfizer is seeking to expand in diseases it knows best, find new growth in the wake of patent expirations and lighten its tax burden.

An acquisition of AstraZeneca would allow Pfizer to move its legal domicile overseas – and according to one estimate, saving the company $1 billion or more in taxes each year – thus providing icing-on-the-deal-cake for Pfizer.

Over the past 12-18 months, a number of US companies have "transitioned out" of the US to Ireland or the Netherlands – using foreign deals to establish new legal residences in lower-tax countries overseas. These transactions – called "inversions" – require companies to transfer at least 20% of their shares to foreign ownership.

The WSJ reported that a Pfizer inversion would also allow the drug maker to deploy cash accumulated overseas without incurring a significant US tax bill. More than 70% of Pfizer's $49 billion in cash is held abroad. Pfizer paid a 27.4% effective tax rate in 2013 – AstraZeneca paid 21.3%. According to Barclay's Bank, *each percentage point in tax reduction could potentially add $200 million to Pfizer's net income*. In addition, the UK tax system would provide Pfizer with a permanent credit for R&D work.

Should Pfizer acquire AstraZeneca and move its "legal headquarters" to the U.K. to take advantage of the country's friendly tax regime, Pfizer could be joined by others. Three of the top accounting firms are supposedly working with over 250 companies in total about relocation to Britain, which is due to cut their corporate tax rate to 20% next year.

Valeant Pharmaceuticals International Inc. – which inverted in a 2010 deal with Canada's Biovail Corp – paid less than 5% of its net income in taxes in its last fiscal year. This provided the Company with a significant advantage over its generic competitors. (Note: Valeant, in combination with an activist investor, recently made a mega-bid for Botox-maker Allergan).

Any Other Pharmaceutical-Specific Trends – And Are Companies Really Transitioning Back To A More Focused Portfolio?

According to industry experts, global pharma companies (like Pfizer) have been rethinking their strategy of portfolio diversification and instead narrowing their focus. This marks a significant strategy shift. Over the past 25 years, as larger companies (including Pfizer) acquired rivals, they expanded their businesses to more diseases and to entirely new segments of health care. This was driven, in part, to soften the blow of lost sales resulting from the "patent cliff" – where some of the biggest blockbuster drugs faced patent expiration. Unfortunately, the combined companies didn't produce enough blockbuster drugs and found that they were too small in a new business to be competitive. In addition, the threat of the "patent cliff" somewhat diminished.

A recent example of this "more focused strategy": Novartis AG, GlaxoSmithKline PLC and Eli Lilly & Co. just announced $20+ billion in deals. Specifically,

- Novartis will sell its animal-drugs business to Eli Lilly and most of its vaccine business to Glaxo,
- Novartis will buy a portfolio of cancer therapies from Glaxo,
- Novartis and Glaxo will group their nonprescription products – such as pain relievers like Exedrin and Panadol – in a joint venture

The companies confirmed that the deal objective "was to focus each firm on specific sectors where it believes it has the size and expertise to generate significant sales growth".

The CEO of Eli Lilly said, "It's understanding what you're good at, what your core competencies are and making sure you're at scale to pursue opportunities in that space..…..there is a trend of companies enhancing what they do better and what they do best, and growing their presence in these spaces".

Other examples of a "more narrowed focus" include:

- Pfizer selling its infant-formula business in 2012 and exiting the animal-drugs business in 2013,
- Bristol-Myers Squibb Co. divesting its infant formula business in 2009 and concentrating on cancer treatment drugs,
- Merck & Co. announcing the sale of its consumer care business to Bayer in May

This strategy change and resultant M&A activities, however, may leave companies more vulnerable to setbacks in their remaining businesses.

In addition, M&A transactions typically disrupt a company – business units may be disconnected or integrated and employees may be shuffled in and out.

What's Driving Medical Device-Specific M&A?

The medical device sector has been consolidating as companies – including Zimmer/Biomet – seek additional size, economies of scale and growth opportunities in new business areas.

What Do Analysts Say Is Driving The Zimmer Deal?

Med-tech industry analysts have offered the following:

- "With consolidation happening across the healthcare industry, management teams seem to believe bigger is better. Bigger medical device firms have cost advantages and are able to bundle products putting smaller companies (particularly those undifferentiated technologies) at a disadvantage" (Matson/Needham).
- "In healthcare, being a larger company that has a broader product offering seems to be the way that things are evolving. You're selling to hospitals as opposed to individual surgeons and having that larger footprint is believed over time to be important" (Denhoy/Jefferies).
- "Consolidation in the $45 billion global orthopedics market was a long time coming. In hips and knees there are five pretty large players all competing for the business of the hospital and the surgeon and most people looking at the industry……would say the economics work better for everyone if there were fewer" (Miksic/Piper Jaffray).
- "The deal was even more important for Biomet, as hospitals look to shore up profit by consolidating vendors. There are a lot of orthopedic makers out there right now and the smaller ones were at great risk of being left behind. So for Biomet to hook up with one of the larger players, it really saved their business over the long haul" (Wang/Morningstar).
- "It's the latest in a spate of deals, led by Novartis AG and GlaxoSmithKline Plc, that show companies are adding depth and expertise as the focus on cost and innovation in health care intensifies" (McGorman/Bloomberg).

What's Does Zimmer Say Is Driving Its Megadeal?

The opportunity to combine the two businesses – and move Zimmer more firmly into the # 1 position in the global knee and hip markets, and into a solid # 2 position in the overall orthopedic market behind Johnson & Johnson (while leap-frogging Stryker) – was a major driver behind the deal.

According to Zimmer:

- "(The) combination is certainly about growth, together the combined company will be more competitive in our knee and hip franchises with a more diverse revenue base to increase scale and faster growing markets in adjacent categories";
- "We will also gain meaningful entry into sports medicine and we will have a research and development teams that will power and enhance innovation";

- “Our success will be in our ability to leverage the combined experience and capabilities of both companies. To offer more personalized solutions that benefit patients across the continuum of care”;
- “Our combined company will be supported by a research and development spend capability of approximately $360 million and will immediately benefit from a combined portfolio of innovative solutions as well as efficiencies gained from combining each companies respective R&D efforts”;
- “This includes game changing solutions in categories such as early intervention and joint preservation, personalized devices, intelligent instrumentation as well as value based offerings for emerging markets”;
- “We will have enhanced diversification and strong scalable platforms in faster growing sports medicine, extremities and trauma product categories”;
- “This together with enhanced scale and other categories will benefit the full spectrum of our key constituents and address current market demands while also growing the market in other category such as knees, hips, surgical spine and dental”; and,
- “Both companies have strong sales force teams to achieve cross selling opportunities as early as day one”.
- The transaction is expected to close by March 31, 2015

What Are The Multiples, What Does The Combined Company Look Like, And What Will It Be Valued At?

- Zimmer will acquire Biomet for a combination of $10.35 billion in cash and aggregate number of shares of Zimmer common stock valued at $3 billion
- Acquisition price translates to a trailing 12-month sales multiple of 4.4x and a trailing 12-month EBITDA of 18.1x
- The 2013 combined calendar year revenues of Zimmer and Biomet total approximately $7.8 billion, with combined adjusted EBITDA of $2.8 billion. Zimmer expects to achieve net annual synergies of approximately $270 million (~5-7% of the combined cost base) by the third year following the closing of the transaction, with approximately $135 million anticipated in the first year. The transaction is expected to be double-digit accretive to Zimmer's adjusted diluted earnings per share in the first year following the closing.
- Market analysts suggest that the equity in the new combination will be valued at roughly $20 billion – or about 17x earnings, while Zimmer/Biomet will operate with a net debt position of around $10-$11 billion.
- Due to the significant debt incurred, Zimmer will focus on reducing leverage – and may be constrained in successfully concluding other material transactions – for example, in spine, sports medicine or lower extremities.
- Zimmer’s dividend will be maintained at 15-20% of earnings and share repurchases will be at least temporarily suspended.
- Zimmer may also be required to divest certain product lines (the early speculation is the uni knee) to guard against any potential anti-trust issues.

Conclusions

- Confidence has returned to Boardrooms and megadeals in the pharma and device sectors are returning – with the likelihood of disruption within each industry
- Recent pharma transactions are being driven by a combination of market pressures, the increasing complexity and cost of drug development and the lingering hangover from patent expirations

- In Pfizer's bid for AstraZeneca, the Company is seeking to expand in diseases it knows best, find new growth in the wake of patent expirations and lighten its tax burden through a proposed "inversion" transaction
- Pharma companies have also been rethinking their strategy of portfolio diversification and instead narrowing their focus – concentrating in areas where they have the scale to compete rather than maintaining a small presence in numerous markets
- This strategy shift and resultant M&A activities, however, may leave companies more vulnerable to setbacks in their remaining businesses

- The medical device sector has been consolidating as companies seek additional size, economies of scale and growth opportunities in new business areas

  - In Zimmer's proposed acquisition of Biomet, the opportunity to combine two businesses – and move Zimmer more firmly into the # 1 position in the global knee and hip markets and into a solid # 2 position in the overall orthopedic market behind Johnson & Johnson -- was a major driver behind the transaction
  - Market analysts suggest that the equity in Zimmer/Biomet will be valued at roughly $20 billion -- or about 17x earnings, while the combined companies will operate with a net debt position of around $10-$11 billion. The significant debt may constrain Zimmer from successfully concluding other material transactions in the short and mid-term
  - A transaction of this magnitude will disrupt the combination company in the short-term, creating opportunities for competitors as they seek to convert Zimmer/Biomet surgeons, and hire away their sales reps. It will be interesting to see if Zimmer takes a page from pharma's playbook and divests its combined dental business – in an effort to secure a "more focused" orthopedic portfolio and pay off debt.

It may be even more interesting to see if large US-based medical device companies pursue the "Pfizer path" and seek inversion transactions – acquiring companies in select countries outside the US, moving their legal headquarters to that country to reap tax benefits.

Don Urbanowicz is Principal of Urbanowicz Consulting, an advisory firm with a musculoskeletal focus seeking to enable clients to achieve strategic and transaction-related goals by capitalizing on market opportunities. UC offers a unique perspective on how large global companies approach strategy, valuation, negotiations, due diligence and integration, and a thorough understanding of achieving success throughout all phases of the transaction process.

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