Merging and Acquisition Perspective in the Pharmaceutical Industry

Abstract
The objective of this article is to give an overview on merging and acquisition in the pharmaceutical industry. A merger has been defined as an arrangement whereby the assets, liabilities and businesses of two (or more) companies become vested in, or under the control of, one company (which may or may not be one of the original two companies), which has as its shareholders, all or substantially all the shareholders of the two companies. The acquisition process is very complex, with many dimensions influencing its result. Achieving acquisition success has proven to be very difficult, while various studies have shown that 50% of acquisitions were unsuccessful. Pharmaceutical companies have limited profits due to restrictions in product pricing, so they have to think of other strategies. Add value to companies by increasing corporate control in the market. This paper also focuses on the trend of merging and acquisition deals in the pharmaceutical industry in the past 10 years. This paper also studies the motive behind merger and acquisition deals, and the reasons for failures of merger and acquisition deals in pharmaceutical companies.

Key words: Merging and acquisition, dimensions, globalisation, liberalisation

Introduction
A merger is a combination of two companies to form a new company, while an acquisition is the purchase of one company by another in which no new company is formed. Mergers and acquisitions (M&A) are the area of corporate finances, management and strategy dealing with purchasing and/or joining with other companies. In a merger, two organisations join forces to become a new business, usually with a new name. Because the companies involved are typically of similar size and stature, the term “merger of equals” is sometimes used.

In an acquisition, on the other hand, one business buys a second and generally smaller company which may be absorbed into the parent organisation or run as a subsidiary. A company under consideration by another organisation for a merger or acquisition is sometimes referred to as the target.

A merger, acquisition, or co-marketing deal between pharmaceutical companies may occur as a result of complementary capabilities between them. A small biotechnology company might have a new drug but no sales or marketing capability. Conversely, a large pharmaceutical company might have unused capacity in a large sales force due to a gap in the company pipeline of new products. It may be in both companies’ interest to enter into a deal to capitalise on the synergy between the companies. The distinction between a “merger” and an “acquisition” has become increasingly blurred in various respects (particularly in terms of the ultimate economic outcome), although it has not completely disappeared in all situations. From a legal point of view, a merger is a legal consolidation of two companies into one entity, whereas an acquisition occurs when one company takes over another and completely establishes itself as the new owner (in which case the target company still exists as an independent legal entity controlled by the acquirer). Either structure can result in the economic and financial consolidation of the two entities. In practice, a deal that is an acquisition for legal purposes may be euphemistically called a “merger of equals” if both CEOs agree that joining together is in the best interest of both of their companies, while when the deal is unfriendly (that is, when the target company does not want to be purchased) it is almost always regarded as an “acquisition”.

Most organisations look to mergers and acquisitions (M&A) and other such partnerships as one of their first options to addressing the problems they face. The big pharma companies look to the smaller companies and biotech to provide competences or additional resources to help spur R&D as well as marketing and sales (M&S) growth, and the smaller companies in turn get much-needed funding to continue their work, either as partners or as a part of the larger company.

1. Buy Growth Companies – activity primarily aimed at increasing the growth of prescription sales
2. Buy Scale Companies – activity to increase product pipeline, R&D, M&S etc.
3. Multi M&A Companies – employ two or more of the strategies
4. Organic Growth Companies – avoid M&A as a core strategy

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<th>Number of M&amp;A strategy</th>
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Table 2: Four classified M&A growth strategies
The goal is to take a look at examples of M&As that have occurred and to provide some perspectives on how each combined company performed. It is not meant to be an in-depth study of the various kinds of M&As – see Table 2.

Discussion
An acquisition or takeover is the purchase of one business or company by another company or other business entity. Such purchase may be of 100%, or nearly 100%, of the assets or ownership equity altogether, and neither of the previous companies remains independently. Acquisitions are divided into “private” and “public” acquisitions, depending on whether the acquired or merging company (also termed a target) is or is not listed on a public stock market. An additional dimension or categorisation consists of whether an acquisition is friendly or hostile.

Whether a purchase is perceived as being “friendly” or “hostile” depends significantly on how the proposed acquisition is communicated to and perceived by the target company’s board of directors, employees and shareholders. It is normal for M&A deal communications to take place in a so-called “confidentiality bubble” wherein the flow of information is restricted pursuant to confidentiality agreements. In the case of a friendly transaction, the companies cooperate in negotiations; in the case of a hostile deal, the board and/or management of the target is unwilling to be bought or the target’s board has no prior knowledge of the offer. Hostile acquisitions can, and often do, ultimately become “friendly”, as the acquirer secures endorsement of the transaction from the board of the acquire company. This usually requires an improvement in the terms of the offer and/or through negotiation.

“Acquisition” usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger and/or longer-established company and retain the name of the latter for the post-acquisition combined entity. This is known as a reverse takeover. Another type of acquisition is the reverse merger, a form of transaction that enables a private company to be publicly listed in a relatively short timeframe. A reverse merger occurs when a privately held company (often one that has strong prospects and is eager to raise financing) buys a publicly listed shell company, usually one with no business and limited assets.

As per knowledge-based views, firms can generate greater values through the retention of knowledge-based resources which they generate and integrate. Extracting technological benefits during and after acquisition is an ever-challenging issue because of organisational differences.

1. Merger and Acquisition Strategy
Before any strategy is formulated, a company needs to have a clear-cut policy regarding merger and acquisition. This policy must be complementary to its vision and mission. Once a policy decision to expand business through merger and acquisition has been taken, the first step is to establish a ‘Merger and Acquisition Cell’. The roll of the cell would be to identify the potential companies, which would depend on macro-level issues discussed above and the broad guidelines laid down by the company for such a move, e.g. to diversify the business or expand the existing business or for upgrading the technology. This cell should be assisted by business analysts, representatives of financial institution/investment bankers, technical experts, valuators and lawyers specialising in this field. For faster decision-making, which is vital in such cases, the cell must have direct access to the business leader/decision-making authority. Sophisticated software that can handle financial analysis, projections, valuation, and so on is available in the market and help can be sought from this source. Once the targeted company has been identified,
the option of finalising a deal through negotiation must be considered. However, if that is not feasible for any reason and takeover is vital for the organisation, a hostile takeover should be considered. For a hostile takeover, the stock of the targeted company should be bought quietly through a third party. The whole process must be managed confidentially.

**Components Model of Acquisition:**

1. Improper documentation and changing implicit knowledge makes it difficult to share information during acquisition.
2. For the acquired firm, symbolic and cultural independence which is the basis of technology and capabilities are more important than administrative independence.
3. Detailed knowledge exchange and integrations are difficult when the acquired firm is large and high-performing.
4. Management of executives from the acquired firm is critical in terms of promotions and pay incentives to utilise their talent and value their expertise.
5. Transfer of technologies and capabilities are the most difficult tasks to manage because of complications of acquisition implementation. The risk of losing implicit knowledge is always associated with the fast pace of acquisition.

An increase in acquisitions in the global business environment requires enterprises to evaluate the key stakeholders of an acquisition very carefully before implementation. It is imperative for the acquirer to understand this relationship and apply it to its advantage. Retention is only possible when resources are exchanged and managed without affecting their independence.

**2. Documentation**

The documentation of an M&A transaction often begins with a letter of intent. The letter of intent generally does not bind the parties to commit to a transaction, but may bind the parties to confidentiality and exclusivity obligations so that the transaction can be considered through a due diligence process involving lawyers, accountants, tax advisors, and other professionals, as well as businesspeople from both sides.

After due diligence is completed, the parties may proceed to draw up a definitive agreement, known as a “merger agreement,” “share purchase agreement” or “asset purchase agreement”, depending on the structure of the transaction. Such contracts are typically 80 to 100 pages long and focus on four key types of terms:

- **Conditions**, which must be satisfied before there is an obligation to complete the transaction. Conditions typically include matters such as regulatory approvals and the lack of any material adverse change in the business.
- **Representations and warranties** by the seller with regard to the company, which are claimed to be true at both the time of signing and the time of closing. If the representations and warranties by the seller prove to be false, the buyer may claim a refund of part of the purchase price.
- **Covenants**, which restrict operation of the business between signing and closing.
- **Termination rights**, which may be triggered by a breach of contract, a failure to satisfy certain conditions, or the passage of a certain period of time without consummating the transaction.

**3. Snapshot of M&A Results**

The performance of the combined companies was assessed using a variety of financial measures, such as:

- **Profit margin** (earnings before interest and taxes/total revenues)
- **Capital turnover** (total revenues/capital employed)
- **Return on capital employed** (EBIT/capital employed)
- **Market capitalisation**

Of the 22 transactions large scale (i.e. valued above $5 billion) M&A activities studied, Data Monitor found that only three delivered fast growth performance over the next five-year period. The study results had the following observations: “Only three M&A events have delivered fast growth performance over subsequent five year period”.

- Only small-sized acquisitions have delivered subsequent fast sales growth performance over the next five years (Centocor, Knoll and Genentech).
- No big or medium-sized acquisitions have contributed to fast sales growth performance in the next five-year period.
- Nearly all big and medium-sized acquisitions have delivered a flat sales growth performance in the five-year period after the merger.
- Only two large-scale acquisitions have provided medium sales growth performance in the five years after the merger (Warner-Lambert, acquired by Pfizer; and Zeneca, acquired by Astra).

It is important to note that the small or flat growth in many ways stabilised their balance sheet in an environment where many of them are facing patent expiry over the next few years as the so-called ‘patent cliff’ looms. This is seen as relative success to many because without this small growth, many companies would have had a steep decline in growth as their branded products lost patent protection.

The current healthcare situations will continue to impact the companies as the after-effects of the recent recession continue to reverberate around the world. This is truly a global economy and the business environment continues to evolve even as companies continue to implement new approaches to improve their product pipeline and look for new patients and markets to serve. While doing this they need to do rigorous business assessments to ensure that their strategies are financially sound, informed by strong portfolio management to target areas where they can provide novel medicines in therapeutic areas not addressed, address rigorous process improvement to ensure that they maintain and improve their operations to gain efficiency and minimise safety issues and institute comprehensive risk management in almost everything they do. Additionally, the one area that should not be underestimated is the effort it will require to integrate companies after a merger. They will also need to set up organisations to make the partnerships successful and do the due diligence to ensure that they are able to operate and conduct business in countries where business and cultural norms are far different from their current experiences.

**4. Merger and Acquisition Motives**

4.1 Improve Global Competitiveness

All the economies above, created through combination and exploitation of common resources, can also be called structural economies. By reorganisation we mean...
a dynamic process reappraising, or even destroying, the last structure for a new one. The “organised” sector of India’s pharmaceutical industry consists of 250 to 300 companies, which account for 70 per cent of products on the market, with the top 10 firms representing 30 per cent. However, the total sector is estimated at nearly 20,000 businesses, some of which are extremely small. Approximately 75 per cent of India’s demand for medicines is met by local manufacturing. Global competitiveness has increased. To survive on the world platform the pharmaceutical companies are using merger and acquisition as a strategic tool.

4.2 Move Up the Value Chain
The strategic decision of acquiring is thus based on the strong will to create value. Facing such a matter, company’s managers and board members need to understand the distinct concept of the value when judging a proposed acquisition. Mergers and acquisitions are motivated generally by two kinds of income: cost savings (or economy of cost) and increased revenues.

4.3 Create and Enter New Markets
Both multinational companies (MNCs) and domestic players are also examining the prospects offered by the local market as the government moves forward with initiatives aimed at providing India’s more than one billion inhabitants, for the first time, with access to the life-saving drugs they need. A further huge boost to the local market is coming from the rise of India’s new affluent consumers, who lead more Western-style lives and are demanding innovative drugs to treat the chronic illnesses that these changing lifestyles may produce. India’s leading drug manufacturers are becoming global players, utilising both organic growth through the gradual development of their business, and mergers and acquisitions.

4.4 Increase their Product Offering
As already explained, the R&D function is extremely expensive and the company’s size will determine the possible amount of investment. Like marketing, R&D is a supporting function, but is able to create a long-term competitive advantage. The merging of R&D will concern particularly the means available, and the resources in terms of competencies. Thus they can increase their product offering by utilising the various synergies.

4.5 Consolidate their Market Shares
The market share growth results from the transfer of the market share from the target to the bidder. The market share of a firm corresponds to the proportion of production volume or the turnover the firm possesses in a given sector of a global market in relation to other competitor companies. The growth concept is relative to a quantitative increase of its turnover or its production. If the company growth is higher than that of the competitors, the growth concept means that the company has a market share growth, but if all the competitors increase their turnover, there is not an increase of the market share. Thus, an entity expands its market share when turnover volume (sales) increases compared to its competitors.

4.6 Compensate for Continued Sluggishness in their Home Market
India currently represents just US $6 billion of the $550 billion global pharmaceutical industry, but its share is increasing at 10 per cent a year, compared to 7 per cent annual growth for the world market overall. Also, while the Indian sector represents just 8 per cent of the global industry total by volume, putting it in fourth place worldwide, it accounts for 13 per cent by value; and its drug exports have been growing 30 per cent annually. The “organised” sector of India’s pharmaceutical industry consists of 250 to 300 companies, which account for 70 per cent of products on the market, with the top 10 firms representing 30 per cent. However, the total sector is estimated at nearly 20,000 businesses, some of which are extremely small. Approximately 75 per cent of India’s demand for medicines is met by local manufacturing.

4.7 Obtaining a Good Buy
While the acquiring firm lists “obtaining a good buy” as a reason for their acquisitions, the underlying implication that markets may consistently undervalue corporate assets is questionable. If all potential acquirers have similar perceptions about the value of potential targets and the market for corporate control is competitive, then the potential acquirers would bid up the price of targets which appeared to be bargains until the acquiring firms would, at the margin.

4.8 To Improve the Efficiencies
Firms may combine their operations through mergers and acquisitions of corporate assets to reduce production costs, increase output, improve product quality, obtain new technologies, or provide entirely new products. The potential efficiency benefits from mergers and acquisitions include both operating and managerial efficiencies.

4.9 Financial and Tax Benefits
Pharmaceutical companies have limited profit margins due to their governing legal frameworks. Mergers and acquisitions may lead to financial efficiencies. Firms may diversify their earnings by acquiring other firms or their assets with dissimilar earnings streams. Earning diversification within firms may lessen the variation in their profitability, reducing the risk of bankruptcy and its attendant costs. A lot of tax benefits are available and companies are taking advantage of that.

4.10 Reasons for Failure of Merger and Acquisition
It is very difficult to estimate how many mergers and acquisitions in the pharmaceutical industry have succeeded. It is even more difficult to define what success means. Some estimate, however, that close to 80 per cent of mergers do not meet their pre-merger financial goals and that almost 50 per cent are failures. The common measure of stock market reactions one day – or even a few months – after the merger is undoubtedly inadequate. In many mergers and acquisitions shareholders’ value is created for the short term only, but more important is that positive synergy should be retained for the long term. On the analysis of available literature, in spite of theories that the stock market, in evaluating and valuing a merger, takes into account all the managerial and human factors, they clearly do not reflect the human and cultural costs of mergers – particularly in light of the fact that the managers and leaders involved in a merger often voice their inability to predict its exact outcome.

4.11 The Paradox of Manager vs. Shareholder
The strategic investments of the firm should aim to create value for the owners of the firms, especially the shareholders. Nevertheless, most acquisitions in the last decades seem to generate poor performance concerning the acquiring firms, and even when the results appear to be positive, they are lower for the bidders’ shareholders than those of the targets, and the value which is generated in the process is retained for a very short
period of time. Different studies therefore prove that the acquisition strategies would benefit the targets’ shareholders by creating value. But this does not hold true in every scenario. There is hence a misunderstanding of the stakes of the acquisition game from both sides. Such a discrepancy can only lead to bad acquisition strategy and planning. This leads to a clash between the management of the company and the shareholders of the company.

4.12 No Planned Integration Cost
The peculiarities of external horizontal growth are based on the combination of two entities, and especially of tangible, financial and above all human, resources. The bidding company and the target, whatever their activities, are composed of men and women living within the firms’ communities. The rules, the behaviours and the customs mean the culture is specific to each entity. The cultures of both entities may be mixed, and their combination may result in efficient synergies, but they can also be incompatible and lead to failure. There is also a lot of reorganisation and restructuring in the company during the days when the M&A process is going on. The process of M&A by which a company is bought or sold can prove difficult, slow and expensive.

4.13 The Problem of Social Compatibility
The risk of demotivating is very high in the case of horizontal mergers. In fact, in such a type of acquisition, there are numerous duplications, which lead to mergers of several business units, therefore to large employee cutbacks. Such an assumption is even more verified when the bidder and the target used to be direct competitors. Such a situation entails anxiety, linked to asymmetric advantages, autonomy loss, and different cultures.

4.14 Difference in Working Culture
It is also unsuccessful because the merger of two organisations is actually a merger of individuals and groups working in companies; this has a great impact on individuals working in a company such as creating ego clashes among individuals working in a company.

4.15 Miscommunication regarding Strategies
There is also failure of M&A when the purchaser’s plans and strategies are not clear to the employees of the acquired firm. Merger and acquisition helps a company to grow in a better way, but it has a great impact on the employees working in a company and on working conditions. The employees of the companies merging and acquiring are mostly affected by M&A. For this reason, there is mostly a failure of M&A. When two companies who have different styles of functioning merge, there is a clash between the companies which pulls them in different directions apart from their aims. A company enters into M&A activity without recognising the impact on the organisation and the overall effect on the human element within the two merging companies. When M&A activities do not meet corporate objectives it results in lost revenue, and customer dissatisfaction. Many personnel issues such as salaries, benefits and pensions are also affected due to M&A. Since the organisational structures are different, differences in compensation packages and designation can routinely be expected.

Conclusion
Pharmaceutical mergers and acquisitions add value to the companies by increasing the corporate control in the market. Serial acquirers appear to be more successful with mergers and acquisitions than companies who only make an acquisition occasionally. Preservation of tacit knowledge, employees and documentation are often difficult to achieve during and after an acquisition. Strategic management of all these resources is a very important factor for a successful acquisition. The key principle behind merging a strong company is to create shareholder value over and above that of the two companies. It is also important to assess the impact of combining on innovations, as mergers and acquisitions in innovative markets may pose a threat for subsequent entry of new products by stifling competition at the R&D and product development stage.

References
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