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Why pharma megamergers work

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Unlike deals in many industries, big mergers and acquisitions among pharmaceutical companies generally have resulted in positive returns to shareholders.

Conventional wisdom holds that large mergers have destroyed value in the pharmaceutical industry. Market commentators insist that these deals don't work, that the challenges of large-scale integration unnecessarily disrupt the organization and critical programs, and that research and development productivity suffers. These critiques have some merit but ignore larger points: megamergers have created significant value for shareholders, and some of these deals have been critical for the longer-term sustainability of acquirers. In short, we believe that the benefits often warrant the disruption that these deals entail.

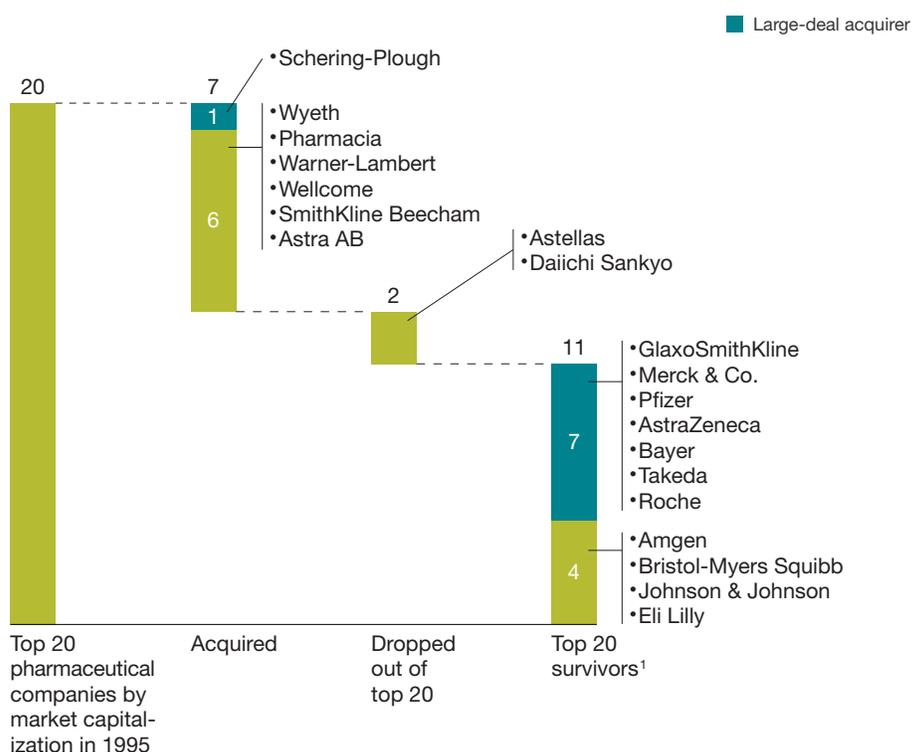
Perhaps that explains their popularity. Megamergers have played a key role in shaping the global pharmaceutical landscape. Indeed, most of the pharmaceutical companies that stayed among the world's 20 largest between 1995 and 2005 were involved in "megamergers," which we define as deals larger than \$10 billion in which the target company boasts at least 10 percent of the acquirer's sales and 20 percent of the acquirer's market capitalization (Exhibit 1). To examine the real impact of megamergers, we analyzed 17 large deals that occurred between 1995 and 2011, looking at excess total shareholder returns above the pharmaceutical-industry index of the acquiring company in the period two to five years after the merger was announced. We also evaluated postdeal revenue growth, margins, new-product introductions, and the product pipeline for the combined company, along with the relative contribution from the acquired company.

Our analysis led to three conclusions.

1. Megamergers created shareholder value

Median excess returns for megamergers in our sample were positive, showing returns 5 percent above the industry index two years after a deal's announcement. This is in contrast to large deals in other industries, which have had marginal returns relative to industry indexes or, in the case of deals in the technology sector, sharply negative returns (Exhibit 2).

Exhibit 1 Most of the pharmaceutical companies that have stayed at the top were large-deal acquirers.



¹ Still among the top 20 pharmaceutical companies by market capitalization as of Dec 31, 2012.

Source: Dealogic; TPSI; McKinsey analysis

What's more, the median acquired company in our sample contributed around 37 percent of total pharmaceutical revenue and 10 percent of new-product revenue for the combined company five years after the deal's announcement. In our analysis, combined companies expanded earnings before interest, tax, depreciation, and amortization (EBITDA) margins by four percentage points two years after a deal's announcement, while the return on invested capital (ROIC) rose 14 percent. Acquiring companies emerged from these mergers with a larger revenue base and leaner cost structure, increasing economic profit by an average of more than 50 percent in the two years following the transaction.¹

¹ We did not explicitly analyze the impact of these deals on tax rates, but we believe that in several of these transactions, the lower effective tax rate of the combined entity materially increased cash flows.

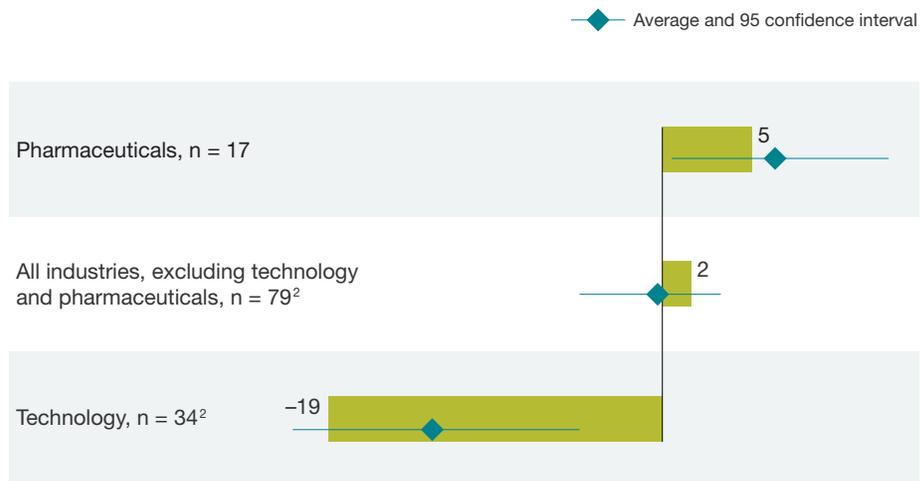
2. Consolidation deals generated greater economic profit

We also classified megamergers into two broad types—those that consolidated existing players with significant overlaps, and growth-oriented deals that created new companies

Exhibit 2 Pharma megamergers have outperformed large deals in other industries.

Median excess returns for acquirers 2 years postdeal¹

%, n = 130



¹ Total returns to shareholders for the acquirer in excess of the MSCI World Pharmaceuticals Index; measured over the 2-year period starting at the end of the month prior to announcement.

² Includes deals by the top 1,000 companies by market capitalization globally in Dec 1999 in which equity value of deal was at least 30% of the acquirer's market capitalization; for details on methodology, see Werner Rehm, Robert Uhlener, and Andy West, "Taking a longer-term look at M&A value creation," *McKinsey on Finance*, Jan 2012, mckinsey.com.

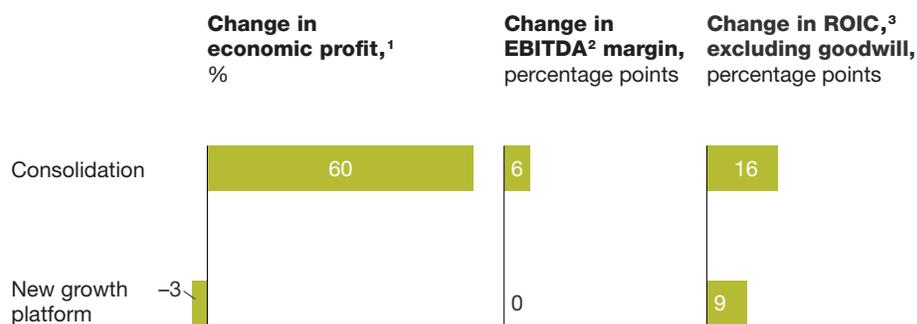
Source: Dealogic; TPSi; McKinsey analysis

or expanded into new markets. Consolidation deals have historically generated the greatest economic profit for acquirers (more than 60 percent growth), while growth-platform deals have on average generated negative economic-profit growth with marginal improvements in ROIC (Exhibit 3). Among consolidation deals, there was significant variation in how the acquirers drove economic-profit growth—accelerating revenue, improving the cost of goods sold, reducing overhead, promoting R&D rationalization and consolidation, or improving working capital—which suggested further segmentation of deal types.

Consolidation deals were more typical in the mid- to late 1990s, and these deals created meaningful economic profit for acquirers through both cost synergies and accelerated revenue growth. Pfizer's acquisition of Warner-Lambert, which was announced in 1999, drove significant value creation for shareholders as EBITDA margins expanded by more than 10 percent, aided by the wildly successful growth of Lipitor. Sales of Genentech products enjoyed a compound annual growth rate of more than 4 percent for several

Exhibit 3 Consolidation deals have generated the greatest economic profit for acquirers.

Combined company 1 year before deal vs 2 years after deal



¹ Economic profit = net operating profit – the cost of capital; cost of capital = (weighted average cost of capital) * (invested capital, including goodwill); we assumed a weighted average cost of capital of 9%; for details on economic profit, see Chris Bradley, Angus Dawson, and Sven Smit, “The strategic yardstick you can’t afford to ignore,” *McKinsey Quarterly*, Oct 2012, mckinsey.com.

² Earnings before interest, taxes, depreciation, and amortization.

³ Return on invested capital.

Source: Dealogic; TPSi; McKinsey analysis

years after Roche acquired full ownership. (Genentech remained a stand-alone operating unit.) In addition, a third of product launches of the combined company and more than 40 percent of the current Phase III pipeline can be traced back to Genentech, which is the highest R&D output of all of deals in our database. Conversely, the Pfizer-Wyeth merger resulted in an overall decrease in economic profit for Pfizer. While significant costs were cut and the merger buffered a declining legacy Pfizer portfolio, the EBITDA margin for the combined company improved by just one percentage point in the two-year period after the transaction due to headwinds from patent expirations. The legacy Wyeth portfolio contributed insufficient incremental on-market revenue growth and new-product launches to offset patent expirations, and economic profit for the combined entity declined by 26 percent.

Megamergers aiming to create a new growth platform have become more common recently, but they are also more expensive for acquirers and generate lower cost synergies given limited operational overlaps compared with consolidation deals. Some mergers created a new company, while others involved moving into new markets (Sanofi and Genzyme) or geographies (Takeda and Nycomed).

3. Growth-oriented deals changed longer-term expectations

On the surface, the average trading multiple for acquirers in our sample changed little after a deal. Yet there was wide variation between consolidation and growth-oriented megamergers. Multiples declined by around 5 percent for consolidation deals closed after 2000—it appears that while these deals generated superior near-term gains in economic profit, they ultimately did not address or solve longer-term issues with business models. In contrast, growth-platform deals increased trading multiples by more than 60 percent, or 20 percent relative to top 20 peers, often from a very low multiple for the acquirer before the deal. One possible explanation for this difference in long-term expectations is the growth contribution that acquired companies made in launching new products. For growth-platform deals, the acquired company contributed around 24 percent of new-product revenue of the combined company five years postdeal, compared with just 10 percent in consolidation deals. The difference in multiple evolution and long-term expectations is reflected in the total return to shareholders (TRS): for consolidation deals, excess returns are positive three years after the merger but turn negative after five years; for growth-platform deals, TRS is consistently positive through the five-year mark.

While the bias of pharmaceutical megamergers has more recently turned toward creating growth platforms and away from consolidation, we found that shareholder returns have historically been positive for both types of deals. However, much of the excess return from growth deals has been generated from multiple expansion and improvement in long-term expectations rather than changes in fundamental operating performance. As drug pipelines unfold and the profile of these new growth platforms is better understood, not all of these deals may look so rosy. Given the proven track record of consolidation deals generating economic profit, we would not be surprised to see them come back in vogue. □

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