

M&A Practice and Pharmaceuticals and Medical Products Practice

A new prescription for M&A in pharma

Adopting a through-cycle approach to deal making in the wake of the COVID-19 pandemic can position pharmaceutical companies for greater success in the next normal.

by Jan Ascher, Roerich Bansal, Ajay Dhankhar, and Edward Kim



The world continues to reel from the effects of the global pandemic: US unemployment is at its highest level since the Great Depression, and the worldwide economy is projected to contract by –4.9 percent this year, according to the International Monetary Fund’s latest update,¹ even as governments launch massive stimulus programs to help businesses and individuals weather the storm.

In the midst of this turmoil stands the pharmaceutical sector, doing its part to help resolve the crisis. Many have linked the world’s economic recovery to the sector’s timely development of effective tests, vaccines, and other therapeutics to combat the novel coronavirus. At press time, there were more than 2,000 clinical studies for COVID-19 therapies² and more than 165 preclinical and clinical studies³ for SARS-COV-2 vaccines under way.

Even as pharmaceutical companies are working at breakneck speed to support broader COVID-19 response and recovery efforts, they are taking time to step back and reassess and update their *own* strategies to succeed in this next normal. After all, companies in this sector are subject to the same digitization, affordability, cost containment, R&D, and regulatory shifts that companies in other industries are facing—trends that have only accelerated in the wake of COVID-19. (See sidebar, “How the crisis is accelerating healthcare trends.”)

M&A, long a key lever for creating value in pharmaceuticals, will and should remain a big part of pharmaceutical companies’ strategies postpandemic. McKinsey research from past economic crises shows that companies that adopt a through-cycle M&A mindset, renew their M&A blueprints, refresh their M&A capabilities, and pursue transactions with purpose can put significant distance between themselves and the competition.

Why M&A remains a core lever for value creation

Historically, pharmaceutical companies have been motivated to pursue M&A for three core reasons:

- **Innovation.** The fragmented nature of innovation in this industry, in which many small compounds and processes must come together to make one big successful drug, will continue to prompt pharmaceutical companies to acquire smaller, more creative firms—inside and outside the industry—to gain new platform technologies, digital talent, or regulatory and policy expertise.
- **Economies of scale.** It is expensive to develop, manufacture, and market pharmaceutical products. For this simple reason, there will always be pressure on industry players to find ways to cut costs, or to realize production, distribution, or other efficiencies. As they are in other industries, acquisitions, mergers, and joint ventures and strategic partnerships are good ways for companies to make these kinds of financial and operational gains, quickly.
- **Portfolio realignment.** Pharmaceutical companies are managing commercial pipelines that are years in the making, and they face steep patent cliffs for drugs that do succeed. It is therefore critical for them to continually monitor and refine their product portfolios. To fill gaps in cash flows, for instance, they may decide to divest noncore assets and enter new or adjacent therapeutic areas. Because their strategies will inevitably change—perhaps even more so now, in this highly uncertain pandemic period—portfolio realignment remains an ongoing task for executives in pharmaceutical companies.

Just ahead of the COVID-19 pandemic, M&A activity in pharmaceuticals was soaring, with \$414 billion worth of deals in 2019, an all-time high (exhibit).

Overall, the pharmaceuticals sector had more than doubled its global M&A from 2005 to 2019. There is no evidence yet that the economic fundamentals of the sector have changed in a way that would slow this trajectory. In fact, we believe the sector is likely to resume its M&A activity sooner rather than later, given the following factors:

¹ “A crisis like no other, an uncertain recovery,” World Economic Outlook Update, International Monetary Fund, June 2020, www.imf.org.

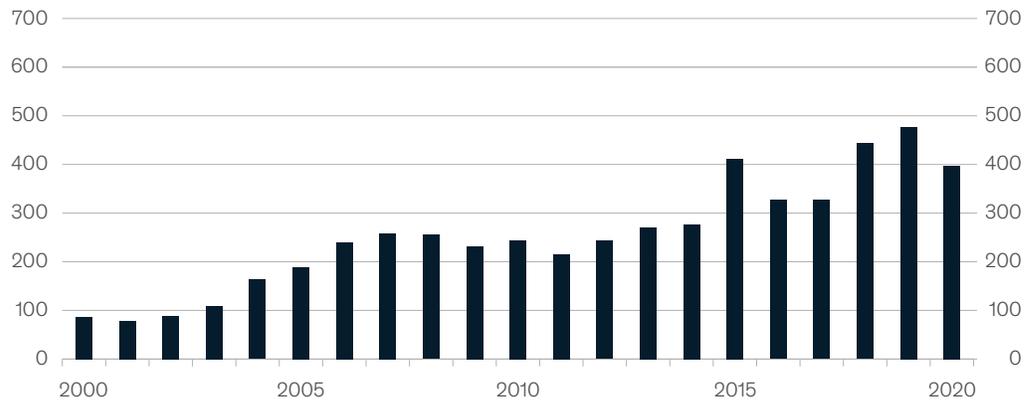
² Clinical studies from the World Health Organization Database, US National Library of Medicine, August 2020 (updated weekly), clinicaltrials.gov.

³ According to the World Health Organization, there were 142 preclinical and 24 clinical trials under way in July 2020.

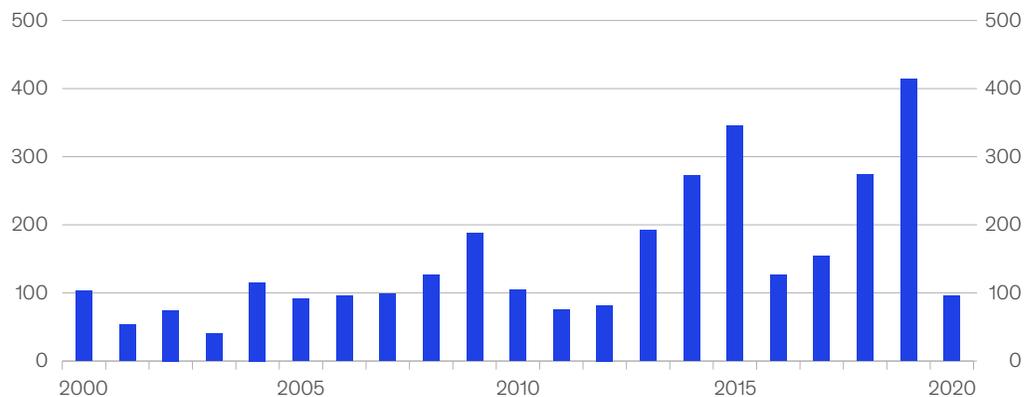
Exhibit

M&A activity in pharmaceuticals was at an all-time high ahead of the COVID-19 pandemic.

Pharmaceutical deal count,¹ number



Pharmaceutical deal value,¹ \$ billion



¹Includes announced biopharma deals (not withdrawn) with more than \$25 million in deal value. As of Aug 24, 2020
Source: Dealogic

‘Dry powder.’ In general, companies with excess cash reserves tend to engage in M&A more often than peers. And right now, according to various sources, the top dozen global pharmaceutical companies have more than \$170 billion in M&A dry powder (or excess reserves) on their balance sheets—\$76 billion in excess cash and \$94 billion in debt capacity.⁴

Reallocation of capital. Our analysis shows that the pharmaceutical sector historically has returned up

to one-third of available cash flow to shareholders through buybacks. For political, economic, and strategic reasons, this is unlikely to continue through the COVID-19 crisis. As a result, more capital may be available for investment in strategic or opportunistic acquisitions.

How companies can bolster their M&A capabilities

To succeed with their M&A programs, pharmaceutical companies should pursue deals

⁴ S&P Capital IQ, spglobal.com; company filings.

How the crisis is accelerating healthcare trends

The COVID-19 pandemic has tilted the playing field for companies in all industries. The following five trends will have significant consequences—and sooner than expected—for healthcare and pharmaceutical companies.

Challenges to globalization. Protectionist policies in major economies prompted negative growth in global trade in 2019. The last time the world saw similarly negative growth was during the 2008 credit crisis. The pandemic will likely accelerate this trend further. For instance, pharmaceutical companies seeking to revise their global production footprints and supply chains may experience stronger pushback from policy makers that want to safeguard domestic production capabilities and capacities.

Rising influence of China. Chinese companies are pushing the boundaries of digital and analytics innovation in healthcare. Pharmaceutical companies seeking innovation and distribution opportunities in China need to be aware of the thriving pharmaceutical ecosystem there, with more than 150 new molecular entities in clinical trials.

Affordability and austerity. Ahead of the pandemic, there was talk worldwide about an impending economic recession. The signs were there, but none could have predicted that the novel coronavirus would hasten the economic downturn. During the last recession in 2008, overall spend-

ing on healthcare continued to grow in most developed countries. But countries with weaker economies, like Greece, Portugal, and Spain, enacted a series of policy changes that led to decreased prices on pharmaceuticals and greater restrictions on reimbursements. In the new normal, policy makers will similarly need to revisit their priorities. In turn, pharmaceutical companies will need to take a closer look at their pricing and product portfolios, in the mid- and long term. For instance, they may experience less support for high-priced innovative therapies—even if those therapies provide material medical benefit to specific patient groups.

Pace of innovation. More than ever, it is important for leaders in pharmaceutical companies to consider which scientific and commercial bets they are willing to make. A range of new modalities, or methods of treatment, have emerged over the past decade, including bi-specific monoclonal antibodies, recombinant proteins, tissue-replacement therapies, and cell and gene therapies (CGT). There are now hundreds of CGT companies worldwide, and in a public statement from the US Food and Drug Administration (FDA), then-Commissioner Scott Gottlieb and Director of the Center for Biologics Peter Marks said the FDA could approve between ten and 20 CGT-based therapies by 2025.¹

It's also worth noting, however, that large-cap pharmaceutical companies' return on investments in R&D have decreased

significantly over the past decade. And predicted peak sales per R&D asset have gone down by more than half in that same period. The pandemic may prompt a temporary slowdown in the adoption of the latest technologies and further pressure on R&D returns.

Digitization and consumerization of healthcare. Patients have become even more concerned about personal health issues than they were before COVID-19 emerged, and they are even more digitally engaged with their diseases. Many are now reluctant to visit a hospital but more open to sharing and leveraging personal health data to prevent illness. At the pilot launch of Switzerland's COVID-19 contact-tracing app, for instance, 59 percent of survey respondents said they were willing to install it on a personal device—this despite the fact that it was one of the first such apps in the world. There has also been an explosion in telemedicine over the past six months, as well as increased demand for digital disease management and digital therapeutic products and services—made possible by some easing of regulatory constraints. And physicians say they expect more digital than physical engagement with pharmaceutical companies going forward.² In the wake of these changes, pharmaceutical companies will need to reconsider their product portfolios (how many can and should be digitally augmented?) and their go-to-market models (how can they better combine digital channels with in-person touchpoints?).

¹ "Statement from FDA Commissioner Scott Gottlieb, MD, and Peter Marks, MD, PhD, director of the Center for Biologics Evaluation and Research on new policies to advance development of safe and effective cell and gene therapies," US Food and Drug Administration, January 15, 2019, [fda.gov](https://www.fda.gov).

² Ortal Cohen, Brian Fox, Nicholas Mills, and Peter Wright, "COVID-19 and commercial pharma: Navigating an uneven recovery," April 2020, [McKinsey.com](https://www.mckinsey.com).

The top dozen global pharmaceutical companies have more than \$170 billion in M&A dry powder (or excess reserves) on their balance sheets.

with three key dimensions in mind: competitive advantage, capacity, and conviction. All three can help executives ensure that they are going after the right targets and getting the most value from them.

Competitive advantage: Update your portfolio and M&A strategy

Pharmaceutical companies need to systematically assess the shocks induced by COVID-19 to their overall strategy and business portfolio. They must ask themselves, for instance: Which subsectors will face headwinds and which ones will face tailwinds? Where will new growth come from in the next normal? In which geographies are we underrepresented or underleveraged? Armed with answers to these questions, executives can then update their overarching corporate strategies and identify specific M&A themes and deal-screening criteria that support those strategies.

A pharmaceutical company seeking to use new modalities that have gained popularity due to COVID-19 may refine its corporate strategy to focus on “innovation” and its M&A themes to focus on “cutting-edge technology companies” as potential targets. In establishing M&A themes that correspond with corporate strategy, the company can assure senior leadership’s buy-in to potential deals early, winnow out deals that don’t fit the description, and act quickly on opportunities that do. A biopharmaceuticals company, recognizing that customers’ needs have changed in the wake of the pandemic, may want to pursue deals and partnerships that involve digitally augmented

products or delivery systems—thereby positioning the company for new data-driven businesses. Still others may use this crisis as a platform for expanding their presence in China or other countries through M&A.

Pharmaceutical companies may also find that they need to upgrade capabilities faster than previously assumed. There is urgent need, for instance, for advanced digital-marketing capabilities, outpatient and at-home solutions, and effective, compliant ways to engage patients directly. They may want to target deals for digital, analytics, and healthcare-technology talent; given economic pressures across all industries just now, it may actually be easier to attract such talent or successfully pursue acquisitions.

Capacity: Prepare to seize M&A opportunities

If we extrapolate from previous crises, we can assume that valuations will likely decrease in 2021. When the dot-com bubble burst in 2002, average EBITDA⁵ multiples (across all industries) stayed high (11.8) but shrank the following year (10.4). In 2008, multiples remained high at 13.1 and dropped to 10.6 in 2009. What accounts for this dynamic? When crisis hits, companies try to avoid fire sales. But as time passes, the urge and willingness to make transactions increases. Valuations do trend downward, and discounts can be found. But pharmaceutical companies must tune out market volatility and focus on determining the intrinsic value of the asset in question—through traditional discounted cash-flow analyses, primarily. They must go through the rigorous exercise of

⁵ Earnings before interest, taxes, depreciation, and amortization.

defining acceptable valuation levels through the crisis, identifying potential targets early, and understanding financial and operational strengths and weaknesses. Companies could, for instance, pursue alternative deal structures in which both parties share risk and rewards and agree to deal terms that don't undermine the acquirer's plans to integrate the target company.

Conviction: Align management and the board on M&A priorities

The pharmaceutical companies that act now to secure executive and board commitment to M&A will be able to act that much more quickly and decisively when opportunities emerge. Business leaders in these companies should carefully choreograph their outreach to various members of the senior management team and the board, presenting a

clear business case for how M&A can add material value to the company—not just in the near term but throughout the COVID-19 crisis and beyond. Doing so can help cultivate a through-cycle mindset among senior management and organization-wide support for M&A.

To many executives, it may seem counterintuitive to think about doubling down on M&A during a time of economic turmoil. Our research, however, suggests that M&A in the pharmaceutical industry remains a powerful lever for recovery in the next normal. The companies most likely to emerge strongly from the COVID-19 crisis will be those agile enough to adapt to their unique situations and pivot their M&A activities toward the most relevant and attractive opportunities.

Jan Ascher is a senior partner in McKinsey's Zurich office, **Roerich Bansal** is a capabilities and insights specialist in the McKinsey Knowledge Center in Gurgaon, **Ajay Dhankhar** is a senior partner in the New Jersey office, and **Edward Kim** is an associate partner in the New York office.

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