"Profitable Growth":

Why Acquisitions Matter at Least in Some Industries"

SAMBA *plus*
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By: Dr. Thomas W. Schrepfer, MBA, LL.M.

Agenda

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Growth: Driver of Shareholder Value and Long-term Survival

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Shareholder Value:

- Revenue growth contributes to 72% of long-term shareholder value (© 2005 Deloitte Research)
- Fortune 500 companies that grow >15% and increase profits >15% augment yields on share by 10.1% on average; whereas companies that grow <5% and increase profits <5% reduce yields on share by 7.5% on average (© Core, University of St. Gallen, 2013)

Relevance:

- 40% of the companies, which grew slower than the GDP dropped out of the Global 1000 between 1999 and 2010 (Global 1000 analysis; Mc Kinsey Quarterly M&A survey, October 2011)

Organic vs. External Growth - Diversity of Evaluation

Fortune 500 Global Enterprise Study (1996 - 2005):

- Only organic growth had a significant positive effect on yields on share, EBIT and ROE growth, whereas growth by acquisitions had no positive effect
- Acquisitions even increase the need for organic growth

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Executives Say &A is Critical to Growth:

Source: Global 1000 analysis; Mc Kinsey Quarterly M&A survey, October 2011

Conventional Wisdom: M&A Destructs Value

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[T]he sobering reality is that only about 20 percent of all mergers really succeed. Most mergers typically erode shareholder wealth … the cold, hard reality that most mergers fail to achieve any real financial returns … very high rate of merger failure … rampant merger failure …[1]

[1]Grubb and Lamb, 2000, Capitalize on Merger Chaos, New York, NY, Free Press

Drivers of Value Destruction

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- Diversification
- Empire building (acquiring greater resource control)
- Glamour acquiring (Buyers with high book-to-market ratios)
- Paying with stock (signaling effect)
- Unclear or badly quantified synergies
- Building market power (anticompetitive combinations)
- Misaligned management incentives (having no skin in the game)
- M&A to use excess cash instead of distributing it to shareholders
- Auctions (buyer's curse)

M&A Profitability: Opportunity Cost vs. Stock Market Expectations

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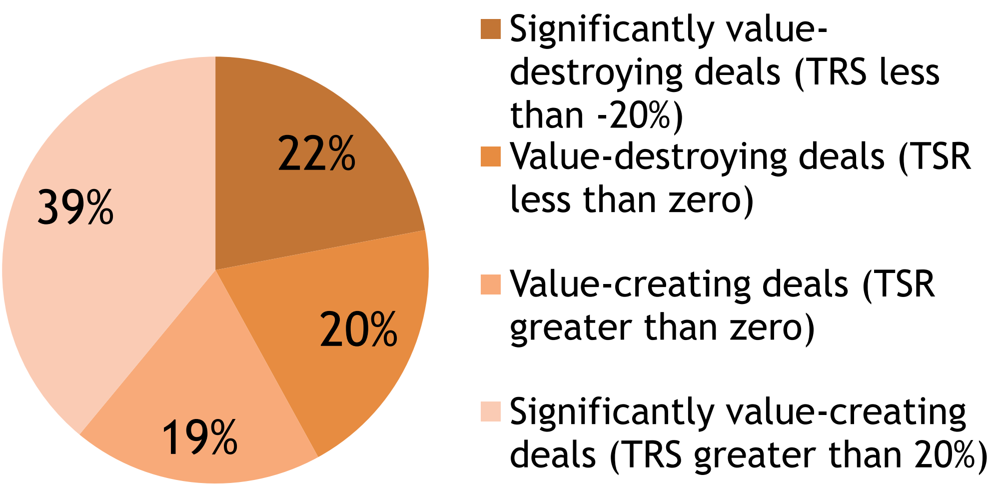
- **Period 1971 to 2001:**

60 – 70% of all M&A transactions covered the opportunity cost but failed short of creating any abnormal value[1]

[1] Robert F. Brunner, Does M&A Pay? A Survey of Evidence for Decision-Maker, Journal of Applied Finance, Spring/Summer 2002

- **Period 2002 to 2009:**

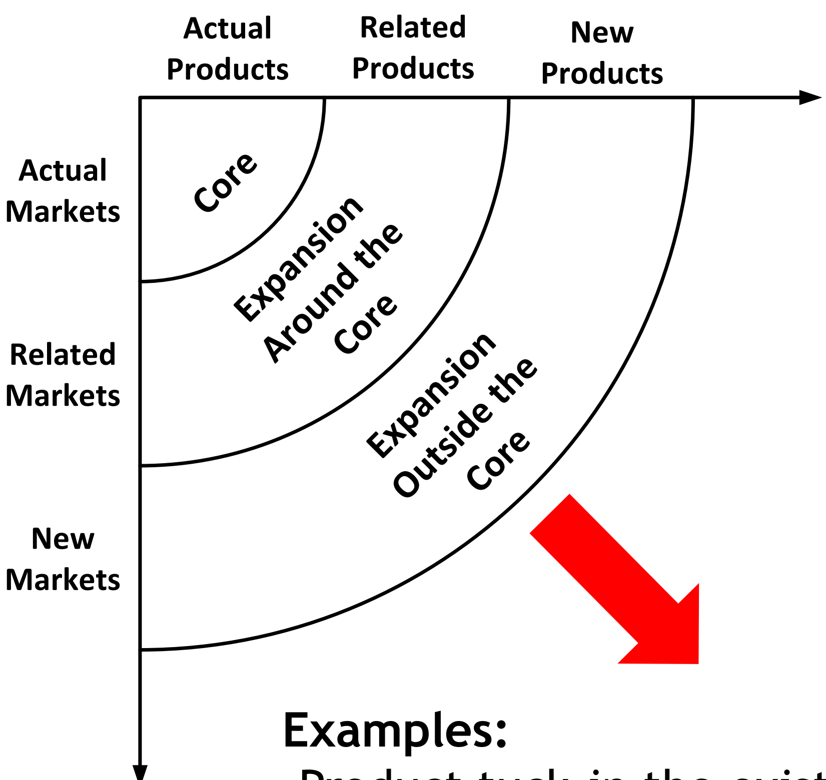
Total Return to Stake-holders (TRS) vs. Industry Benchmark



Source: Accenture Analysis

Creating Growth: Growth Path and Related M&A Deal Types

Growth Path



Related M&A Deal Types:

- Buy to improve
- Buy scale
- Buy scope
- Buy adjacent markets
- Buy geographies

Examples:

- Product tuck-in the existing geography
- Acquisition of a new business in the existing geography
- Acquisition in a new geography

Industry Related Predominance of Specific Deal Types

Due to decreasing margins in their core market Vodafone primarily buys entry to adjacent markets (38%) and entry into new geographies (46%)

Need to replace drugs running out of patent protection and margin erosion (price pressure + increasing regulatory costs) let Sanofi Aventis to focus on buying scale (38%) and scope (50%)

Price competition and market saturation with core products induced Cisco to buy primarily scope (38%) and entry into adjacent markets (55%)

Source: Dealogic, Company annual reports, Bloomberg (2005 – 2008)

Organic vs. External Growth: An issue of Opportunities and Timing

- Growth strategies quite frequently ask for changes in the product/market mix
  - Organic development of products and markets can be too time consuming
  - M&A can be a fast way for companies to scale up their operations, broaden their product portfolio and enter new markets
- Companies should decide on a case to case basis, which road to pursue

Example: Addressing the Growth Gap in the Pharmaceutical Industry

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Decreasing sales: In 2012 and 2013 sales revenues of big pharma companies decreased in absolute USD values

Loose of market share: By 2015 big pharma companies will lose USD 100 billion in annual sales due to their decreasing share of the global drug market

Source: The Global Use of Medicines: Outlook through 2017, IMS Health, 19 November 2013

Growth Challenges of the Pharmaceutical Industry

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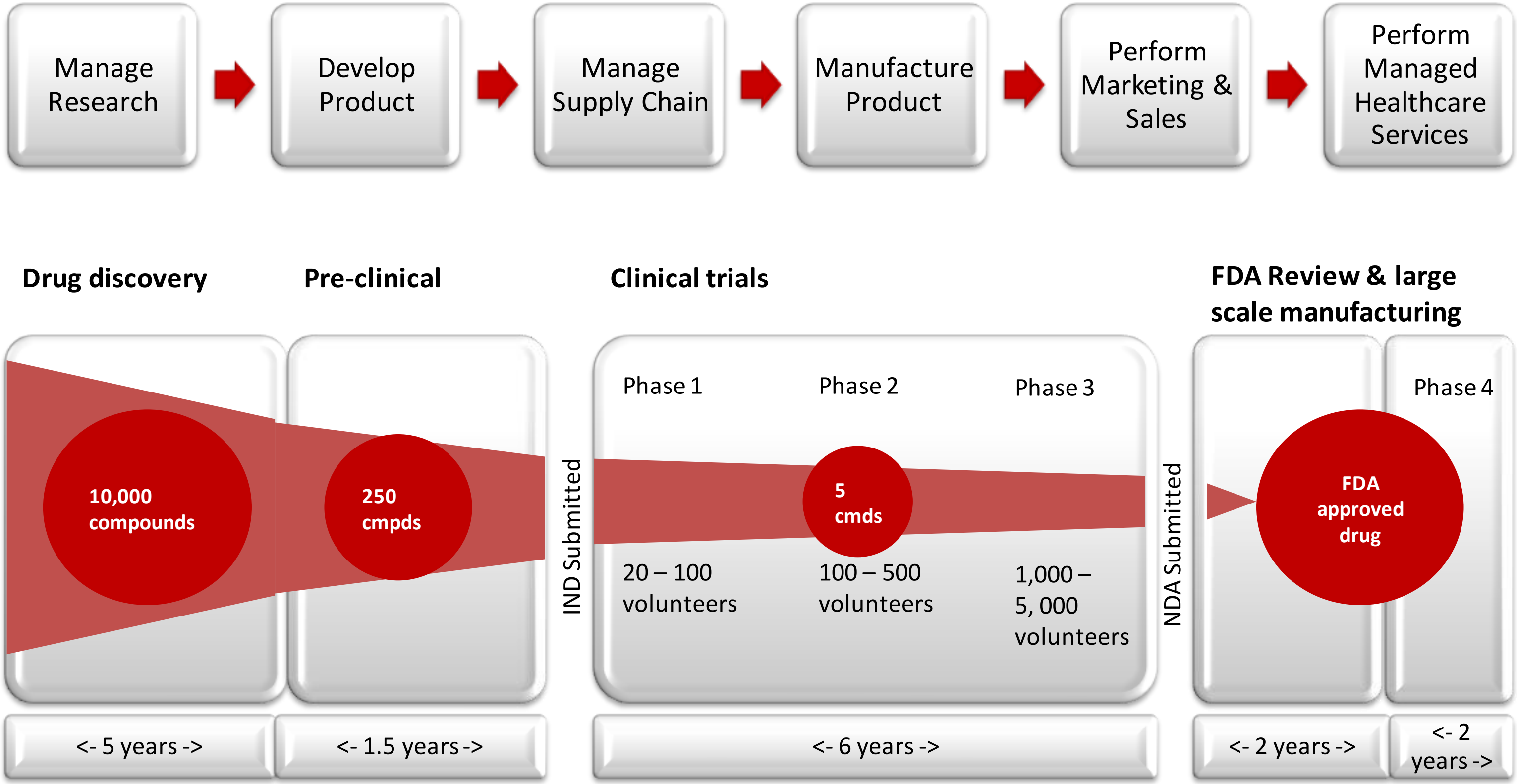
- Host of blockbuster drugs losing patent protection
- Fewer drug approvals due to more stringent approval criteria (superior efficacy in relation to existing drugs)
- Increasing buyer power (private + public)
- Increasing price sensitivity (cost of health care system)
- Cost reductions are getting more and more crucial
- Emerging markets are becoming more and more important

Supply Chain: Source of Constraints



Main constraints:

- Long development cycles with high attrition rate
- Expensive marketing & sales activities

Measures to Address the Growth Gap

M&A

- A top priority is buying companies or in-licensing products for fueling the distribution network
- Overall M&A deal value is increasing
- Focus is not primarily on big takeovers but on competition for assets that have the potential to drive growth

Partnering

- Partnering in product development and marketing and sales activities increases
- Companies spend up to 20% of their R&D budget on partnered products

Measures to Address the Growth Gap (continued)

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Rely on Organic Growth

- In recent years only very few companies have been in a position to rely on their own pipeline of late-stage and newly approved products

Refine and Focus the Business Model

- Some big pharma companies are divesting or have divested non-core businesses; or
- Exit therapeutic areas where they are not a leading player

Case Study: Novartis

- Pursuing all strategic measures in one multi-party transaction (April 2014):
  - **M&A:** Acquiring cancer business of GSK to get to the critical threshold (number 2 behind Roche) for further growing the business organically
  - **Partnering** with GSK in the OTC business (more products, reducing overlapping sales force)
  - **Focusing** business model by divesting the vaccination business (GSK) and the animal health business (Lilly)

Summary

Without profitable growth the long-term survival of a company is at risk

Evidence on M&A profitability is exceeding perception; but pitfalls like lack of strategic fit, unclear synergies and overpaying have to be avoided

M&A and organic growth are not alternatives but viable cornerstones of any balanced growth strategy

Differences in the growth path as well as in the industry structure are asking for different M&A deal types

Depending on the industry structure M&A activities can be the preferred growth option (Pharmaceutical industry)

Caveats or longstanding truth[1]:

- The costs of entry should never capitalize all future profits
- Either the new unit or the buyer must gain some kind of competitive advantage

[1] Michael Porter, From Competitive Advantage to Corporate Strategy, Harvard Business Review, May-June 1987, p. 6

Dr. Thomas W. Schrepfer
Dr.iur., LL.M., MLaw
MBA, EMBA-HSG

Managing Partner
PMIC Advisors Group Ltd.

Stadtturmstr. 19
CH-5400 Baden

Ph: +41 (0) 56 442 49 51
Fax: +41 (0) 56 442 49 50
Mob: +41 (0) 79 407 13 14

Mail: thomas.schrepfer@pmic.ch
Web: www.pmic.ch