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CULTIVATING THE PEARL

CREATING VALUE FROM MIDSIZE BIOPHARMA ACQUISITIONS

By Mark Lubkeman, André Kronimus, and Michael Ringel

After years of cost cutting, the biopharmaceutical industry has reached a point where growth has become the major imperative for creating value. (See *The 2013 Biopharma Value Creators Report: Key Imperatives for Sustaining the Sector's Resurgence,* BCG report, January 2014.) In addition to organic growth, in-licensing, and the occasional "mega-merger," midsize acquisitions—defined as those with transaction values of $1 billion to $15 billion—are becoming increasingly common, as acquirers target smaller companies with promising products, technologies, or capabilities. Examples include Celgene's $2.9 billion purchase of Pharmion in 2008 and Amgen's $10.4 billion acquisition of Onyx in 2013. Some companies, such as Bristol-Myers Squibb, have pursued multiple midsize transactions in a so-called string-of-pearls strategy.

Since 2004, 93 midsize acquisitions have occurred in the biopharma sector, and the pace is accelerating. From 2004 to 2011, an average of about 7.5 such transactions took place per year. From 2011 to 2013, the average increased to 12. In the first two months of 2014, there have already been four such transactions.

Midsize acquisitions can be small in scale relative to the size of the acquiring company but typically play a key role in the acquirer's value creation by providing fresh growth opportunities. Such acquisitions can be risky, however. In particular, many acquirers are discovering that midsize transactions pose unique integration challenges.

When two large companies merge, a major source of value is typically the cost savings that come from rationalizing duplicative functions and operations. For this reason, the postmerger integration (PMI) typically focuses on reducing costs and slotting the acquired portfolio into the management structure of the acquiring company. In midsize acquisitions, by contrast, the main source of value usually comes from accelerating the acquired company's growth potential. Although these acquisitions do have some possible cost synergies, the cost agenda is usually secondary, centering on general and administrative functions, such as finance, HR, IT, legal, and sourcing. Capturing the value implied in the transaction premiums of these deals (about 35 percent, on average, since 2004) requires leveraging the acquired company's capabilities in a particular technology or disease area by enhancing its R&D programs or by accelerating momentum of already-commercialized assets.

These capabilities and assets constitute the "pearl" that is the core of the acquisition, and cultivating them requires a carefully customized and more nuanced approach to integration. Six lessons have emerged from our work supporting this particular type of transaction and the ensuing integration. Many of these lessons also apply to large integrations, but customizing the approach to each midsize integration is what separates success from failure.

1. Be explicit about what drives value. Senior executives at the acquiring company generally understand the value creation potential of the deal. Too often, however, a clear understanding of the value drivers and how to maximize them is not broadly shared. For example, if an acquired product is to be relaunched, how urgently must that relaunch be executed? If certain clinical-development programs are core to the value, how best can they be supported? It is important to articulate early in the process the specific sources of value, all the way down to the level of particular regions, affiliates, and development programs; platforms, products, and molecules; and individuals' knowledge and expertise. In some cases, the acquiring company may also need to change the way it operates.

2. Use a structured integration process—and start it early. We have observed limited scale effects when it comes to PMI. Integrating a small company can be just as complex, and sometimes even more so, than integrating a large company, and can require as many resources to accomplish. The specific approach to integration must also be tailored to each transaction. Midsize acquisitions require a disproportionately higher level of senior management's leadership, time, and attention. It is important not to treat the integration of a midsize acquisition as business as usual by simply handing off the acquired assets to the line executives to integrate as they see fit.

The heavy lifting of the integration is accomplished by middle managers and scientists from each company working together to assess the current state of the companies and to design their postintegration future. A structured approach helps ensure that they make the right design decisions to address each of the critical value drivers. Such an approach also ensures that nothing is missed, that informed decisions are made on accurate information, and that disruption is minimized.

Equally important, planning for integration needs to start early, as an integral part of the due diligence process. Too often, when planning an acquisition, the focus is exclusively on getting the deal done. Then, once the transaction is closed, the PMI is assigned to a different set of managers, who were not deeply involved in the due diligence and negotiations.

Throwing the PMI over the wall in this fashion is never a good idea. But it is especially dangerous when dealing with midsize acquisitions, where the goal is to preserve the value of a new set of assets. The behavior of the suitor during the due diligence process is often a major indicator of the degree of cultural affinity—or lack thereof—between the acquirer and the target. Sending in a brand new integration team after an acquired company has already become comfortable with the due diligence team, for example, is disruptive and can damage the budding relationship. At a minimum, if the team is changed, key assumptions and accumulated learning about the target are lost.

We recommend that acquiring companies appoint an integration leader—ideally, a seasoned, respected operational executive—during the due diligence phase and include that person in the negotiations so that they understand the strategic logic of the deal and how to capture the potential value.

3. Agree on a target operating model and how to apply it. The critical objectives of a midsize acquisition are usually to maintain business continuity and sustain, or even accelerate, the momentum of the acquired company's development projects and marketed products. At first glance, this may seem to be an argument for promoting autonomy or independence—that is, leaving the acquired company more or less alone to continue doing what it already has been doing.

In fact, such an approach can dramatically complicate value creation. Although words like "autonomy" and "independence" may express senior management's general intent to give the acquired company the freedom and flexibility to develop organically, they can create real barriers to revenue synergies because they can be interpreted as a promise not to change the way the acquired company operates.

An effective operating model for a midsize acquisition is not monolithic. It requires careful design during the due diligence process with the active engagement of the integration leader, often function by function and process by process, consistent with certain guiding principles. We typically observe a three-speed operating model in midsize transactions. (See the exhibit, "Midsize Acquisitions Typically Require a Three-Speed Approach to Integration.")

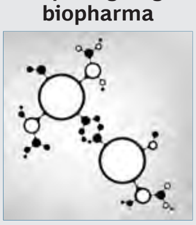
- In some functions, such as pharmacovigilance, quality, and regulatory, the acquiring company is legally required to take full responsibility immediately upon closing the deal.

- In support functions, such as finance, HR, IT, and legal, capturing potential synergies makes it advisable to fold the acquired company's functions and processes into those of the acquiring company over a limited period of time.

- In line functions, such as commercial, R&D, and operations, however, where most of the value will be generated and freedom to operate can be important, it is critical to define in advance exactly how the acquiring and acquired organi-

Midsize Acquisitions Typically Require a Three-Speed Approach to Integration

Acquiring large biopharma



1 Legally mandated

Function
- Pharmacovigilance
- Quality
- Regulatory

Approach
- Acquirer controls immediately
- Focus on effectiveness

2 General and administrative

Function
- Finance
- HR
- IT
- Legal

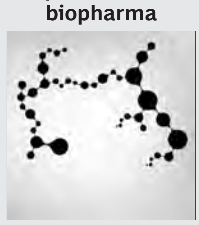
Approach
- Acquirer integrates relatively quickly
- Focus on efficiency and cost strategy

3 Line

Function
- Commercial
- R&D
- Operations

Approach
- Depends on operating model
- Focus on business continuity over time

Acquired midsize biopharma



Source: BCG analysis.

zations will work together over the long term.

We see a number of key questions for clarifying the design of the acquired company's operating model. The following, in particular, should be addressed early in the integration process:

- What will be the operating model of the integrated company, and what organizational structure will best enable that model? What will be integrated, what will remain separate but will adopt the acquirer's policies and processes, and what will remain completely separate? What risks need to be managed?
- Who will do what in the new, combined organization? Who has which decision rights, and how will these change over time? What potential cultural issues are created by these changes?

Before answering these questions, it is important to learn and appreciate what the acquired company does well. Indeed, the acquirer may want to adopt some of the acquired company's practices, such as speed and clarity in decision making or integration of demand forecasting and planning. Setting up joint teams to promote early learning and collaboration can be an effective way to spread such best practices.

4. Identify and retain valuable talent. The ultimate success of an acquisition made to obtain capabilities depends on retaining talent. Therefore, it is critical to engage with key executives, researchers, and other personnel at the acquired company as soon as possible, even during due diligence (subject, of course, to any legal or regulatory constraints), and to understand what it will take to keep them at the company after the acquisition goes through. This is one of line leadership's primary responsibilities. HR may help structure the assessment and retention program, but line leaders must make the decisions.

Three employee groups are especially important: the commercial staff, who will play a critical role in maintaining the acquired company's customer relationships and revenue; the medical staff, who often have long-term relationships with key investigators; and the scientists, who have the expertise and knowledge that is often central to the transaction. For that last group, one especially effective approach is to bring together the scientists from both companies so that they can begin discussing their scientific research—not just the business. Increasing mutual respect between the two R&D units raises the probability that people will stay and collaborate constructively.

5. Integrate the culture, not just the company. Most midsize biopharma companies have strong cultures. Many of their employees intentionally left larger companies because they were looking for a more entrepreneurial environment. Learning that their company has just been acquired, especially if by a large biopharma, can cause strong emotional reactions.

Therefore, keep in mind that everything from mundane announcements about laptop and phone options, travel policies, and cafeteria catering, to more material decisions regarding site closings, job titles, and signing authority are potential drivers of defection. It is critical for leaders to explain the vision for the combined company and the logic behind their integration decisions. Without active leadership in communication and engagement, decisions about the operating model will be viewed with suspicion by employees at the acquired company and dissected for sinister motives in discussions around the water cooler.

To avoid negative reactions, it is important to assess the cultures of the two companies carefully and to understand the similarities and differences between them. Determine which characteristics of the two cultures should be aligned and which should be protected and nurtured. The earlier the integration team articulates its vision for the integrated company and the desired culture, the less likely it will be for misunderstandings to occur during the integration process.

6. Insist on senior-leadership engagement. Finally, it is crucial to understand that even the most intelligently designed integration process depends on active senior leadership. Leaders must drive the integration; they cannot delegate that responsibility. To ensure the appropriate level of senior leadership engagement, the CEO of the acquiring company should serve on the PMI steering committee. Senior management should decide in advance who will lead the acquired company and place that person at the center of the integration process. The integration process should also include a standing meeting of the integration leaders and other senior executives so that pivotal issues are made transparent and leaders assume accountability for taking action.

INTEGRATING A MIDSIZE biopharma acquisition, like cultivating a pearl, is a complex task fraught with risk. Success requires a sharp focus on the value drivers, a tailored approach to integration, and careful execution. The six lessons above, drawn from our experience supporting successful acquisitions, offer a proven roadmap for effective value creation.

In its work on PMI with companies worldwide, BCG has helped its clients generate an 11 percent premium compared with non-BCG-supported integrations. This finding is based on a global study of 659 acquisitions from 2002 to 2011 with a market capitalization of more than $10 billion.

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