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Mergers and acquisitions: A consideration of the drivers and hurdles

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Abstract Mergers and acquisitions (M&A) are increasingly being included by biopharmaceutical companies within earlier stage strategies as a means of accelerating technology development and thus quickening the path to shareholder value. These drivers are generally different from those of the larger established pharmaceutical companies that are more earnings focused. The authors consider some of the drivers of and hurdles to the successful implementation of M&A from both a national and cross-border perspective. In 2000 the number of cross-border transactions increased to 41 per cent of all M&A deals; however, generally, returns from international transactions are much lower. The authors also consider the important issues of determination of the price to be paid and the use of stock as 'currency'.

Keywords: merger, acquisition, M&A, acceleration of technology development, market cap, liquidity, collar, shareholder value

Introduction

The term mergers and acquisitions (M&A) is usually used to define the bringing together of two entities. The objective is always that, post-transaction, the new company so formed is more competitive, more efficient and more profitable than either company alone could be. In the strictest sense a true 'merger of equals' is extremely rare. Generally, there is always an acquirer and an acquiree, despite how it might be portrayed. This does not mean, though, that there is always a winner and a loser, or that the target is necessarily ever the loser. Provided the business reasons of both parties are in line, generally all shareholders should see benefits going forward over the status quo.

M&A can be somewhat loosely likened to

the board game Monopoly. In Monopoly the objective is to use your 'seed money' to obtain a street of properties (technology) and then develop this over time with the building of houses and hotels to maximise revenue. So with biotechnology: the objective is to use early monies to build the technology, continue to add on value over time and eventually to create a significant revenue stream. The ultimate objective in Monopoly is of course to own everything and put the competition out of business. This may be a harder metaphor to make for biotechnology; however, the need to control a piece of technology or therapeutic area, or to gain market dominance, is clearly a similar objective.

As with Monopoly's famous streets, so with technology platforms, some give big

rewards, others are more modest. However, unless you are completely lucky with the throw of the dice, the game requires negotiation and trading with other competitors or the forming of alliances or M&A to stay in the game and be competitive. Entrepreneurial biotechnology CEOs will find many similarities in other aspects of the game, such as the luck of 'Chance' cards – always hoping of course they don't draw the one marked 'Go to jail'!

Why M&A?

For 'big pharma' the main driver is usually earnings growth. M&A can provide economies, both of scale and also through removal of overlap. Cost savings alone may have a positive medium-term impact on earnings and also perhaps in the short term, provided these are not overtaken by the costs of integration. Mergers can also prop up or fill in gaps in a limited pipeline, which may strengthen the R&D profile of the company and reduce some of the risks. Mergers and acquisitions may also be undertaken to gain or reinforce market dominance and/or expand geographical reach.

For early stage biopharmaceutical and biotechnology companies the drivers for M&A are very different from big pharma or more mature companies, reflecting the earlier stage and smaller size of the organisations. In most cases M&A is driven by the positives of mutual recognition that a joining of skill sets may allow acceleration of technology development and thus shorten time to market. Shareholders are usually supportive of risk-sharing strategies, but of course do not favour those mergers that are purely additive, whereby one company's technology risk is added to that of another without obvious benefit. In some cases though M&A may be driven by a need for survival. Delayed technology development (or even failures) may drain cash reserves and investor confidence such that the company is unable to access capital and be forced to put itself up for acquisition.

A significant driver for M&A, especially for smaller private companies, is that of

liquidity. Acquisition by a publicly traded company will give immediate liquidity to shareholders in a private entity. However, M&A between private and public companies is often the most difficult to achieve because of valuation issues. Even though a public company has a value assigned to it by the market, its CEO may well contend that the market has it wrong and does not recognise the company's true higher value. The CEO of the private company, freed from the market's opinion, similarly may also claim a big valuation. Without the market giving it a price then his or her view cannot easily be disproved. Even when 'comps' (comparative companies with a value in the market) are used for estimating a private company's value, the grounds for disagreement remain, as the comps are only indicators and are never the true market test.

M&A may also provide an opportunity for one of the parties to access a more senior investment market, such as a TSE (Toronto) or LSE (London) listed company acquiring a NASDAQ listed company, thus obtaining a US listing. Similarly a smaller private US company, with insufficient critical mass, could by merging with say a Canadian public company, achieve liquidity for its shareholders on the TSE, and then with a greater valuation, the combined entity might obtain a NASDAQ listing, so both benefit.

Market cap and liquidity

Achieving critical mass in valuation (market cap) is an important factor in accessing larger institutional investors. With recent mergers in the financial industry resulting in colossal financial accounts, fund managers are forced to look at larger and larger hurdles as a 'minimum' market capitalisation. Indeed, outside biotechnology, almost any industry considers a valuation below US\$2bn to be 'small cap'.

Investors are hard pressed to make investments in a company with a market capitalisation under US\$250m. A fund manager typically holds between 20 and 40

stocks in an equity portfolio. Therefore, a manager, who may be required to limit his exposure to below 5 per cent share of any given company, would be unable to deploy funds in excess of US\$500m by investing in small-cap biotechnology companies. Combining two companies with a small market capitalisation is one way to overcome these financial hurdles.

Increasing liquidity is another important factor in an M&A strategy. Many companies, although public, have insufficient daily trading volume in their shares for larger investors to want to come in. Institutional investors particularly require a high level of trading to allow them to exit their holding at any time. An illiquid stock makes it difficult for an investor to exit quickly without adversely affect the price, hurting both themselves and the company.

If a company can use a merger or acquisition to increase its market cap and liquidity then it may well see a positive increase in its share price as new investors seek to take a position in the company. This may also increase financing opportunities for the newly merged company if it wants to raise more monies to support the expansion and growth of its operations.

Who can stop it?

Even though the drivers for merging may be different for each company, the outcome must produce desired benefits for all parties if it is to happen smoothly. Even after lengthy negotiations and compromises agreed, the merger may not happen. Boards can stop it, CEOs can stop it and of course shareholders (who ultimately have to approve it) can stop it.

Ironically, often the only individuals who stand to lose their positions are the decision-makers. After any merger or acquisition, there will be only one Board, and personal interests can play a part in the decision-making process. Similarly there can only be one CEO for the new merged company. A CEO, charged with finding a suitable M&A candidate could conceivably be selective with the information and with his or her

choice of candidate companies if insufficient personal benefits to him or her are not evident. Boards should satisfy themselves therefore that there are sufficient checks and balances in place (and/or incentives and/or protection post-merger for the Board Members and CEO).

Importantly, shareholders are usually able to stop completion of the deal, (though in some jurisdictions, local regulations may apply as to size of the deal, eg offeror shareholders for LSE primary listed companies get a vote only if the acquisition is over 25 per cent on various measures). Shareholders will have to vote to support the transaction and allow completion. The documents they receive have to be not only accurate but will need to show clear benefits to them if they are to positively vote their shares. Clearly where there are major shareholders, with large blocks of shares, it is wise to endeavour, within any regulatory framework, to involve them as early as possible in the process so that their shares are voted in support.

Table 1 shows the main drivers of and hurdles to M&A.

What is the price and what is the currency?

Except in a true merger situation, prices paid usually reflect a premium for the acquiree company. In 2000 average premiums to market in all M&A transactions were around 40 per cent, but individual deals varied from 12 per cent to over 100 per cent. Obviously the desire to buy versus the desire to sell has an influence over prices agreed. Price and the premium achieved, though, represent just a snapshot in time. The true price ideally interprets what the value of the new entity will be going forward. Thus if this is correct the price paid should always be at a premium to reflect the future upside benefits of doing the transaction.

Many deals use the concept of a 'collar', which is a mechanism that attempts to capture some of the value that the market may give to the deal (either up or down)

Table 1 Drivers of and hurdles to M&A

	Drivers	Hurdles
People	Access to new skills Access experience Accelerate hiring time	Challenges of rationalisation Dual: multi-site operations
Products	Expand pipeline (more 'shots on goal') Risk management Access 'advancement' technology	Integration of new technology 'Not invented here' syndrome Resource limitations
Finance	Gain critical mass, increase liquidity Increase shareholder base Opportunities to access capital	Valuation disagreements Communicating synergies to financial markets Need to finance

after the announcement and before the final closing. In essence it prevents the acquiring company from over-paying and the acquiree company from losing out if the value of the acquiror's stock (the currency) falls. (It can often also include a 'walk away' for the acquiree if the price drops below the collar lower end.) It also allows the acquiree to share in the upside if on the announcement of the deal the value of the acquiror's stock goes up. (There are occasions also when a collar may be used to deliver a set amount of shares rather than a price range.) The purpose of a collar therefore is to address the issue of volatility in the sector, in that the price (or number of shares) within the collar remains fixed.

Two deals completed recently show what can happen if no collar is in place. Immgenics, a private Vancouver-based company was acquired by Abgenix, a public company in the USA. The value agreed for the company being acquired would be a fixed price payable upon closure, issuing Abgenix's shares to the full value of the price agreed at the time of announcement. Abgenix's stock price fell between announcement and closure; therefore, Abgenix issued more shares so that Immgenics's shareholders received the valuation agreed. Another recent example, Trega Biosciences Inc., based in San Diego, agreed to be acquired by Lion of Germany for a fixed number of shares set at the time of announcement, rather than a fixed price. Between announcement and closing, Lion's share price fell significantly and Trega

shareholders received shares which effectively valued the deal at two thirds less than they had agreed.

The recently announced takeover of Axys Pharmaceuticals by Celera Genomics utilises a collar provision. The collar is described in the companies' joint press release in the following, complicated statement:

The collar mechanism will determine the ultimate exchange ratio delivered to Axys shareholders based on the average closing price of Celera common stock for the 10 trading days up until two days prior to closing. The mechanism provides a fixed exchange ratio of 0.1016 Celera shares per Axys share if the average Celera price is between (and including) \$45.77 to \$48.23. Above this fixed band, there is an upside collar of 25 per cent whereby at average Celera prices of \$48.24 to \$60.29 the exchange ratio will fix the transaction value at \$4.90 per share by providing an exchange ratio based on \$4.90 divided by the average Celera price. In no case however shall the exchange ratio be less than 0.0813 (ie above an average Celera price of \$60.29, the exchange ratio becomes fixed at 0.0813). There is a similar downside collar of 25 per cent whereby at average Celera prices of \$45.76 to \$34.33 the exchange ratio will fix the transaction value at \$4.65 per share by providing an exchange ratio based on \$4.65 divided by the average Celera price. In no case however shall the exchange ratio be greater than 0.1355 (ie below an average Celera price of \$34.33, the exchange ratio becomes fixed at 0.1355).

In actuality, the structure described is

depicted in Figure 1. The bottom line is, Axys shareholders receive some price protection for their shares, but would be at risk of receiving less than \$4.65 per share, equal to AXYS closing price the day prior to the announcement, if the average price of Celera's shares drops below \$34.33. However, there is upside potential too, particularly if Celera's average climbs above \$60.29.

Of course, cash does not deflate or inflate after the deal is announced, in other words you know what you are getting. This can be very important in a volatile market. Cash also has the benefit of minimising dilution to the acquiror company, which may be a significant consideration, particularly if the acquiror is a profitable company that is valued on an earnings multiple. However, cash transactions are rare in the cash-burning biotechnology industry where every dollar needs to be invested in R&D. Also, a cash transaction may carry tax implications for shareholders and this may well influence their view negatively in support of the proposed transaction.

Cross-border M&As

A January 2001 study by KPMG shows that 41 per cent of all 2000 deals were cross-border transactions, up from 24 per cent in 1996.¹ All benefits aside, entering into a merger or acquisition transaction is probably the most disruptive, challenging and time-consuming exercise that a company, its management and board can undertake. These hurdles are significantly exacerbated if the deal involves a cross-border transaction, which often leads to diminished returns in comparison to original expectations. Table 2 shows the drivers of and hurdles to cross-border M&A. A Bloomberg study of the 30 biggest cross-border deals completed in 1998 and 1999 demonstrated an annualised return of less than 9 per cent through March 2001.² Bio-industry deals demonstrate similar phenomena. An analysis of eight deals announced since March 2000, with an average value of US\$470m, have provided an average return of -13 per cent.

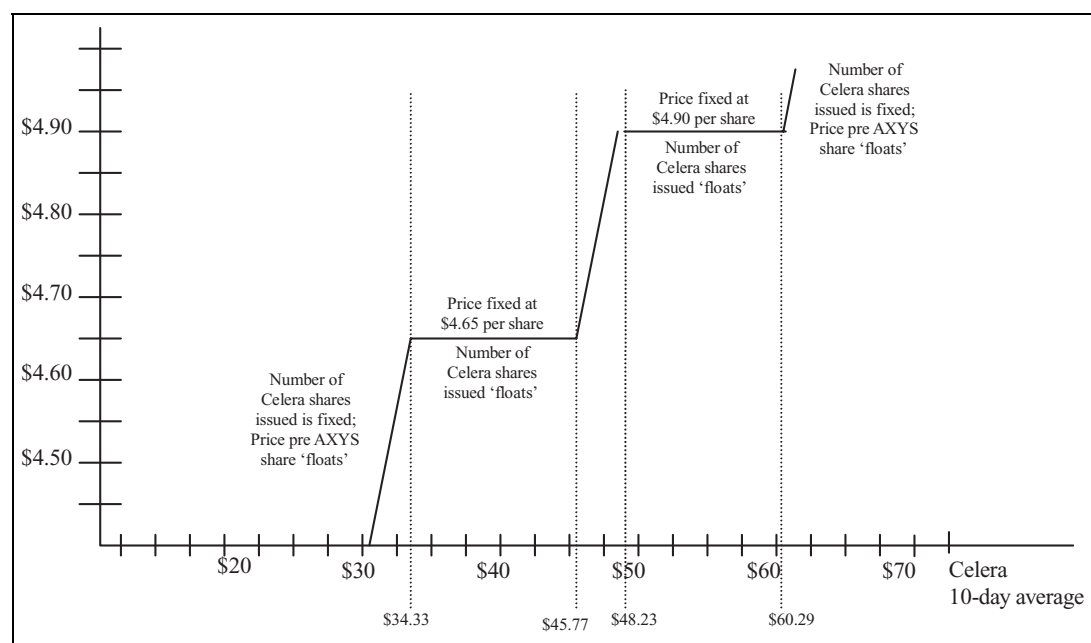


Fig. 1 Collar mechanism in Celera Genomics acquisition of Axys Pharmaceuticals

Table 2 Drivers and hurdles in a cross border transaction

	Cross-border drivers	Cross-border hurdles
People	Access skills not available at home Gain local market experience	Challenges of culture, language and nationalism Salary discrepancies Time zone management Multi-site management Nationalism
Products	Access new markets Enable multi-jurisdictional trials	Local use products Anti-competition rules
Finance	'Street' recognition (particularly in USA) Access larger shareholder base Access new equity markets and sources of capital	Valuation discrepancies may be heightened Wall street is US-focused Multiple exchanges

People

A major hurdle in cross-border transactions is that of staff integration, especially when nationalism comes into play. Even though a 'true' merger is intended – the basic premise for which assumes a combination of equals – in reality this becomes especially challenging as generally one company will be perceived as being on top, no matter how it is portrayed. Some major big-pharma mergers have followed a policy of dividing up the globe and agreeing that if in market X, company A's manager heads it up, then in market Y, company B's manager will be the head – and so on. This approach has merit and a degree of equanimity, which may be explainable to the individuals affected, however, the concept of 'the best manager for the job' is clearly not applied. Fears of redundancies also loom large and may have political implications. Recent press surrounding Shire's acquisition of BioChem Pharma provides the perspective of the potential loss of one of Quebec's crown jewels, and along with it many jobs, through the merger, resulted seemingly in a hesitancy from national authorities to approve the transaction.

The obvious challenges in integrating two distinct corporate cultures are also made more difficult when cultural integration is also a factor. KPMG's report found that the success rate of cross-border deals is improved when the transaction partners have cultural and language commonalities.

Deals involving US and UK companies were found to be 45 per cent more successful than average compared to a figure of 11 per cent less successful than the average for deals between US companies and companies elsewhere in Europe.

Products

In any merger or acquisition, rationalisation almost inevitably occurs. Integration of products/technology is difficult enough in domestic transactions, but even more so in an international setting. This is further complicated by the fact that regulatory authorities may require certain product disposals because of anti-competition rules. Usually the best method to use is to align the projects with the location of the skill base, however many projects may well be dropped if larger product opportunities are now possible.

Finance

Realising the financial benefits of a merger or acquisition is also made more difficult in a cross-border transaction. Public companies trading on regional exchanges are often valued at a significant discount to their US peers trading on the NASDAQ. This is generally not an issue of quality, but of supply and demand. There is simply more money looking for quality investment opportunities on the NASDAQ than on the

Toronto, London or other stock exchanges. However, given the dynamics of a particular economic region and the local markets, one could argue that companies on each are efficiently valued. The question then becomes – what premium would be unlocked by moving to the NASDAQ and what costs are involved in doing so?

Other issues that must be addressed in a cross-border transaction involve issues such as salary discrepancies and the prospect of running a multi-site, multi-continent business with 24 hour trading in the equity markets. None of these is easily addressed.

In conclusion, whether a deal is local or international, a corporate development

strategy involving proactive treatment of M&A can supplement a company's internal efforts to develop its own products, accelerate the implementation of the business plan and importantly grow shareholder value more rapidly, but only if the synergies in people, products and finance are truly exploitable.

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