



## Six ways to make healthcare deals work

Conventional wisdom says mergers and acquisitions (M&A) in healthcare are like rolling dice: It's hard to guarantee success due to the technical, regulatory and commercial risk involved. In reality, if companies follow a tried and tested approach to managing deals, they dramatically improve the odds in their favor.<sup>1</sup> Healthcare companies that excel in the art of the merger outperform acquirers in many other industries. According to the Bain & Company Healthcare Manufacturer Merger and Acquisition Database, consisting of pharmaceutical, biotech, medical device and diagnostics transactions, almost 60 percent of the healthcare deals between 1995 and 2008 generated higher returns compared with peers (see Figure 1). Consider the six factors that contribute to the success of top-performing acquirers:

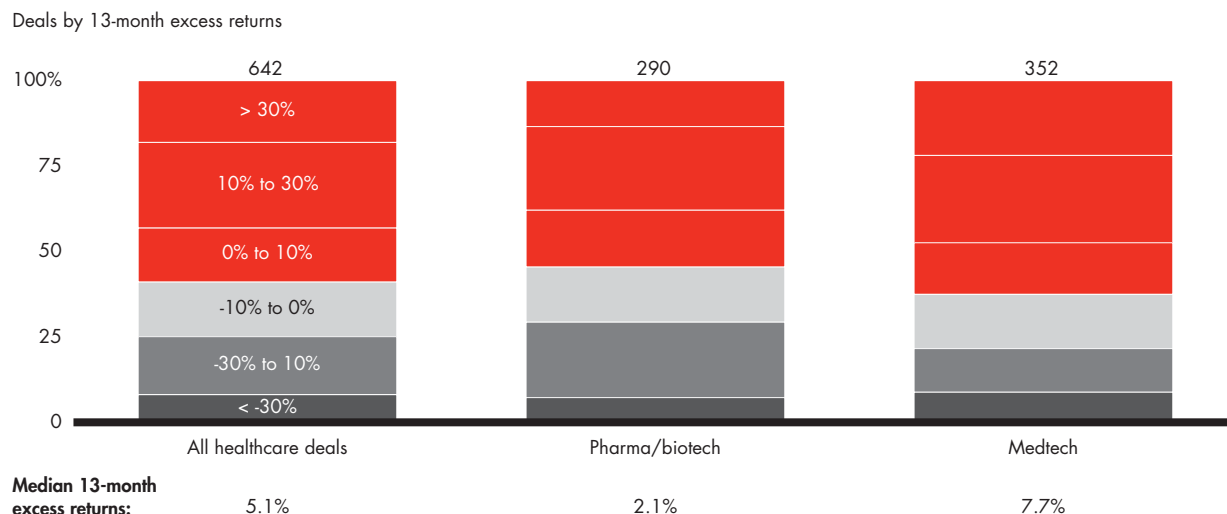
**They maintain a regular pace of M&A activity.** Companies that execute more than one deal every two years steadily build distinctive competencies. Bain's research on "frequent acquirers" shows such companies improve their skills in integrating assets over time.<sup>2</sup> That allows

them to extract more value and achieve higher returns than the market average.

Frequent acquirers in healthcare outperform the market comfortably (see Figure 2). In the last two decades, companies like Abbott Laboratories, Medtronic, Pfizer and Roche successfully invested in more than two dozen deals each. Over time, they built their organizations' "muscles" to execute deals well. Before the transaction, they invest in adequate due diligence and identify potential areas of value realistically. Post-deal, they effectively combine assets and integrate the businesses as quickly as possible. Most important, they ensure that the merger or acquisition does not distract from their core business.

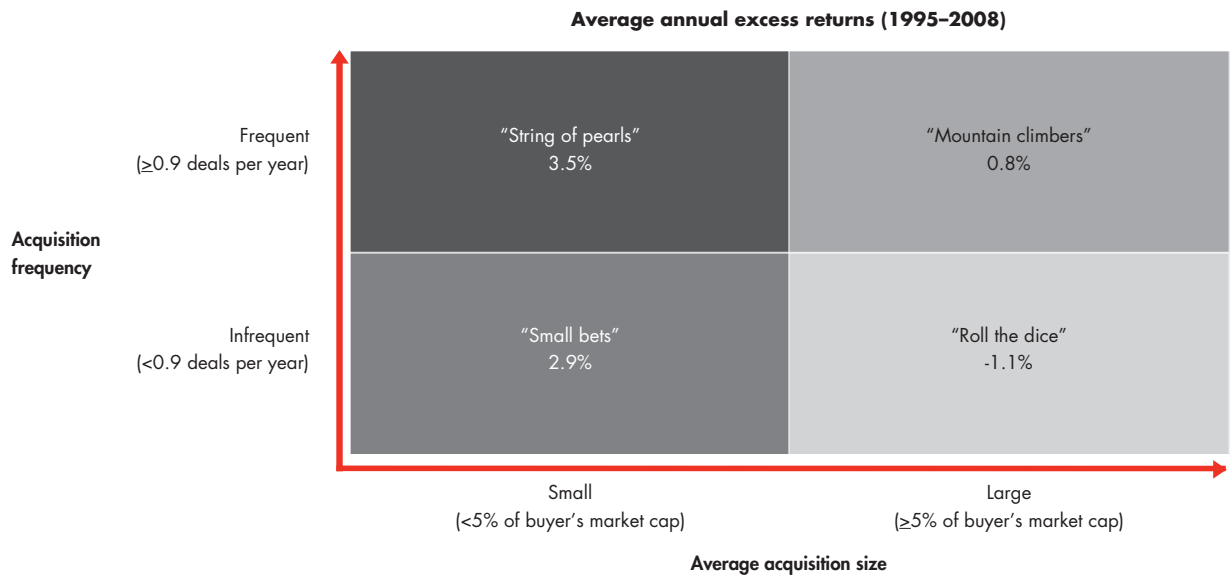
**They focus on smaller "tuck-in" acquisitions.** Smaller, frequent deals tend to support a more comprehensive growth strategy and can often deliver substantially higher returns. Large deals initiated from a position of weakness—for example, after exhausting all other growth avenues—seldom deliver excess returns. A comparison of 13 industries in Bain's Acquisition Success Study shows that, on average, large acquisitions in the healthcare sector *eroded* value for acquirers and performed

Figure 1: Within healthcare deals, pharma deals underperform compared with medtech deals



Note: Comparison of return to S&P 500 relevant sub-sector healthcare indexes performance over same time period for US listed buyers, comparison with S&P Global 1200 Healthcare Index for non-US listed companies. Excludes deals where less than 50% ownership of the target was sought. Data uses month-end share and index prices in US dollars. Deals announced between 1995 and 2008.  
Source: Capital IQ; Bain & Company Healthcare Manufacturer Merger and Acquisition Database

Figure 2: Healthcare deals: “Rolling the dice” is the least successful strategy



Note: Excess return here equals average companies’ annual total shareholder return (TSR) compared with cost of equity calculated using 10-year company betas.

below the industry index. Only three sectors—industrials, transportation and technology—did worse.

Companies that pursue a “string of pearls” strategy by frequently acquiring smaller assets deliver sustainable, higher returns. For example, between December 2008 and January 2009, Johnson & Johnson’s Ethicon unit successfully acquired three companies—Omrix (bio-surgicals), Mentor (aesthetic medtech) and Acclarent (ENT devices)—to fill out its portfolio. Generally, such healthcare acquirers post excess returns close to 3.5 percent, compared with less than 1 percent for those that pursue only larger deals.<sup>3</sup>

**They value internal and external sources of innovation.**

In order to access the best innovative ideas, industry leaders increasingly apply the same analytical rigor to products and technologies whether they come from internal or external sources. That is particularly critical in healthcare, where market leaders rarely command a majority share of the market, and mergers and acquisitions don’t necessarily solve the problem of stimulating innovation.

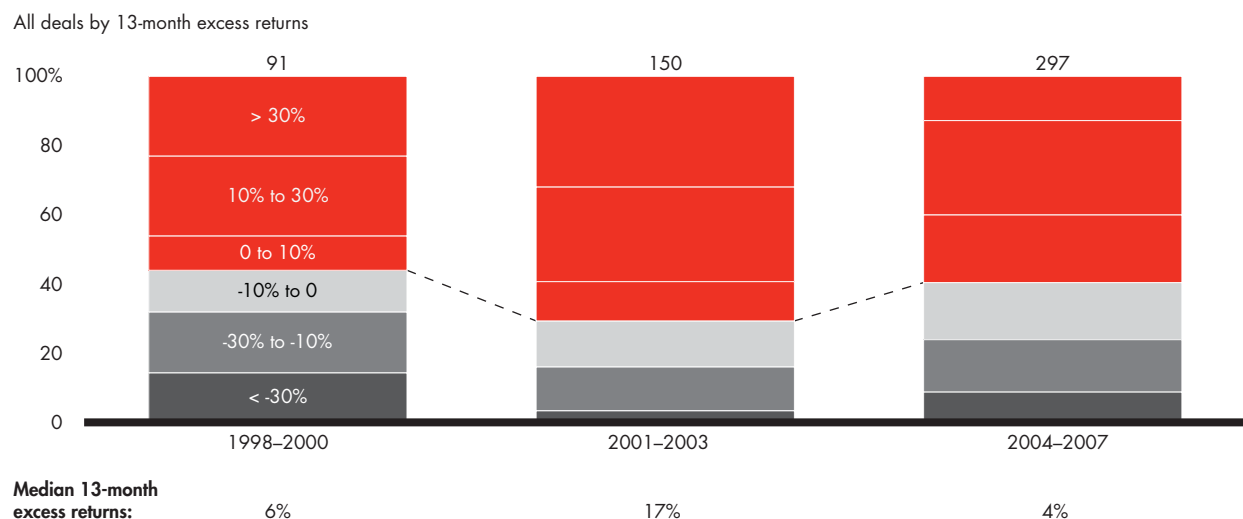
Following the Wyeth acquisition in 2009, Pfizer’s market share grew, but only to 11 percent of the total global

market. Assuming a fairly consistent level of research and development (R&D) productivity across the industry, the combined company can generate only a fraction of the innovation needed to drive sustainable growth. The company therefore must remain open to innovation outside its walls.

**They invest when others don’t.** The economic downturn substantially reduced the number of deals in the healthcare sector. Despite several large, high-profile pharma deals such as Roche-Genentech, Pfizer’s acquisition of Wyeth and Merck’s acquisition of Schering-Plough, the total number of healthcare deals (globally) in 2009 fell to just over half of the average number of deals per year between 2006 and 2008. Nevertheless, experience shows that the more broad based and extended the downturn, the greater the opportunity for the right pharma or medtech company to create significant value through acquisitions. In the 2001 downturn, healthcare acquirers created higher shareholder returns compared with all other industries except telecom and energy.

It pays to play the odds for several reasons. First, slower economic cycles make it easier for acquirers to deliver outsized returns compared with peers (see Figure 3). In the relatively mild downturn of 2001–2003, for

Figure 3: Healthcare deal performance: Strongest during the 2001–2003 downturn



Note: Deals before 1998 are not included in this analysis. Comparison of return to S&P 500 relevant subsector healthcare indexes performance over same time period for US listed buyers, comparison with S&P Global 1200 Healthcare Index for non-US listed companies. Excludes deals where less than 50% ownership of the target was sought. Sources: Capital IQ, Thomson

example, healthcare acquirers outperformed the industry indexes by 17 percent, compared with the preceding period of “irrational exuberance” between 1998 and 2000, when they outperformed indexes by just 6 percent. As the economy recovered between 2004 and 2007, returns posted by acquirers regressed to just 4 percent higher than the industry average. Second, down cycles help buffer the risk for acquirers. While on average 40 to 50 percent of deals fail to create value, the “failure rate” decreases to 30 percent during a downturn. When valuations fall, healthcare companies with strong cash positions can confidently accelerate merger and acquisition activity.

**They invest close to the core.** Deal success is a function of how the acquired asset relates to the core business.<sup>4</sup> Acquisitions that capitalize on existing customer relationships or capability platforms succeed more often. Johnson & Johnson’s Omrix, Mentor and Acclarent deals added value because each acquisition found a place in the company’s existing product and technology portfolio.

In recent years, several leading pharmaceutical and medical technology companies have turned to acquisitions as a strategy to spur growth. Companies shopped for products, technology and even competitors to sup-

plement their R&D pipelines and boost the bottom line. The ones most likely to succeed: those that acquired assets and skills that strengthened the core.

**They approach large deals selectively.** Some healthcare sectors score better than others when it comes to the size of the deal. Between 1995 and 2008, pharma deals yielded 2.1 percent above their sector index, but medtech acquirers did three times better, with excess returns of 7.7 percent. Within pharma, larger-scale acquisitions tended to post substantially higher excess returns. Often, acquirers saved costs by consolidating the commercial and administrative functions of the two pharma companies. Smaller pharma transactions such as product tuck-ins or co-marketing deals posted lower returns (2 percent), reflecting the increasingly competitive licensing and acquisitions market for such deals. In the medtech industry, large and small deals showed comparable results, as these acquisitions focused on the less risky strategy of product- and technology-platform expansion.

Large or small, acquirers capture the full value of the deal only when they avoid the three most common pitfalls of post-merger integration. First, missed targets: Companies fail to define clearly and succinctly the deal’s

primary sources of value and its key risks, so they don't set clear priorities for integration. For pharma companies, the issue becomes complex when R&D pipelines need integration.

Second, the loss of key people often derails efficient integration. Many companies wait too long to put new organizational structures and leadership in place; in the meantime, talented executives and key researchers leave. Pharma companies flounder if they don't address cultural matters—the “soft” issues that determine how people in key areas like R&D and marketing and sales feel about the new environment. Third, the larger the deal, the more the acquiring pharma company has to guard against poor performance in the base business. Often integration soaks up too much energy and attention, or worse, drags on too long. Uncoordinated actions, contradictory communications to customers, or poorly managed systems migrations buffet the business and weaken the core. Competitors quickly step in to take advantage of the confusion.

Despite these challenges, most healthcare companies cannot afford to ignore deals as a path to growth. Bain research on the annual excess returns of companies across industries that had done more than 100 deals over a 10-year period shows they outperformed companies that did no deals at all. The frequent acquirers posted an annual excess return of 3 percent, while inactive companies lost 0.2 percent.

Moreover, the right deal can offset the headwinds pharma and medtech companies face due to increasing regulatory hurdles, price pressures, rising competition, decreasing physician influence and stagnation in innovation. If adequate care is taken pre- and post-transaction and the merger or acquisition results in a robust pipeline of innovative, clinically differentiated products, a pharma company can confidentially hunt for targets. Such deals hit the jackpot when they create value for all stakeholders: employees, payers, physicians, distributors, patients and investors.

<sup>1</sup> David Harding and Sam Rovit, *Mastering the merger: Four critical decisions that make or break the deal* (Harvard Business Press, 2004).

<sup>2</sup> Bain Long-term Acquirer Performance Study.

<sup>3</sup> A company's annualized total shareholder return minus its cost of equity.

<sup>4</sup> Chris Zook and James Allen, *Profit from the core: A return to growth in turbulent times* (Harvard Business Press, 2010).

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