Does biotech M&A benefit investors?

Tom Jacobs

Business mergers and acquisitions invite as much scrutiny and controversy as celebrity weddings. As well they should. Research cited by *The Economist* magazine asserts that 80% of business marriages fail to generate sustained shareholder value. Every company certainly expects to be in that 20%, but the odds don't favor success. So why do they persist, and do biotech investors face the same equation?

D&D

The two broad types of mergers are 'discretionary' and 'desperate.' In discretionary mergers, a Pepsi buys another consumer food brand, or a Bertelsmann adds a mid-size book publisher. Neither deal is about survival. In the old days, managers could only increase their pay through running larger companies, so they created conglomerates regardless of wisdom. Today, there are stock options and other performance incentives to attract and retain talent at smaller companies, but the management school bias to 'Do Something' persists. In this type of merger, we may not be sure that executives are spending money wisely, but in most cases they aren't betting the company.

Desperation mergers are about survival instead of decline and even bankruptcy. Players in an ailing industry may merge to reduce price competition and prolong life, at least until the antitrust forces intervene. Others may seek better financed partners to bolster product development they can't afford alone. Where buying or being bought is the only route past the graveyard, it's certainly better for employees and their community, but not necessarily for investors. They don't face the Hobson's choice of a 20% chance of success or terminal illness. They can sell their shares, and should—unless they see a bona fide turnaround in progress.

Tom Jacobs is cofounder of Complete Growth Investor (<http://www.completegrowth.com/>). He welcomes your comments at tom@completegrowth.com. Tom owns no shares of companies mentioned in this article.

The difference isn't always easy to recognize. Some argue that America Online's buyout of Time Warner (New York; NYSE:TWX) was necessary for both companies' survival. If so, then good for employees, but horrific for investors. The 90% stock price decline post-merger was only somewhat better than a complete loss. Perhaps this was a discretionary merger gone very, very bad.

Biotech is different

For biotechs, mergers and acquisitions are simply facts of life. With product cycles limited by patent term and no benefit from brand name, biotech and all drugmakers must embrace the entire range of alliances, including mergers and acquisitions.

Recent cash hungry times have made this even more essential. At one time, a drugmaker may have sustained growth entirely from in-house R&D, but not for long, and today I can't think of one drug company that's been forever an island, able to burn alone, a gemlike flame. Over 30 years ago, I worked in a drugstore in high school and stocked the shelves with drugs from Hoffman-LaRoche, Ciba-Geigy, Warner-Lambert, Carter-Wallace, and many others that don't exist independently or in the same form today. Most of them were already mergers of other companies.

Required, but effective?

Does research confirm our common sense view that the life cycle of biotechs may require mergers and acquisitions, and if so, does the 80:20 failure to success ratio apply, suggesting that investors consider selling or avoiding a new investment?

In a 2003 Wharton School study¹ of pharmaceutical and biotech mergers from 1988 to 2000, the authors lumped companies into large and small, using \$20 million in sales and \$1 billion in market value as the dividing line. For both large and small firms, the authors found that high propensity to merge was "consistent with merger being a response to distress," whether from financial problems, patent

expirations or limited pipelines. But large firms that merged showed no change in "enterprise value, sales, employees and R&D expenses in the three years following a merger," and had "slower operating profit growth in the third year after the merger." The authors concluded dryly that "although merger is a response to being in trouble for large firms, there is no evidence that it is a solution." Gulp.

For small firms, the authors found that mergers were almost always in response to financial trouble. Yet they reduced sales, employee and R&D growth rates in the first full year following, and with one exception there was no difference three years out between small firms that merged and those that didn't. The difference was that for small firms with the highest propensity to merge—those in the greatest distress—those that did actually merge produced better growth in sales, employees and R&D in their first year after merger than those distressed firms that did not. Perversely, investor expectations for merger success for small firms were so high that the enterprise value (market capitalization plus debt minus cash) of the most distressed small firms three years later was 49% lower than for those that did not merge. Although the business may be relatively better off, investors clearly are not.

No M&Ms for M&A

The investing moral of the story is twofold. First, the authors found that the strongest, best-performing firms did not merge. Investors will find the greatest profit potential in these companies with low valuations relative to growth. Second, if a company of any size is in trouble, it certainly is better for employees and their communities if they merge than not; for investors, however, the expectations for such mergers are so high that the results are usually mediocre or worse.

1. Danzon, P., Epstein, A. & Nicholson, S. *Mergers and Acquisitions in the Pharmaceutical and Biotech Industries* (Wharton Business School, Philadelphia, PA, 2003). http://hc.wharton.upenn.edu/nicholson/pdf/merger_Sept03.pdf