Life Science Leader
Connect. Collaborate. Contribute.
JANUARY 2018

MERGERS | PHARMA ACQUISITIONS

Recurring Mistakes (And Remedies) For Life Sciences M&As

DR. ODED BEN-JOSEPH AND THOMAS BUSBY

As members of a specialized life sciences investment banking group focused on private equity financing and M&A, we often note that life science management teams fall victim to recurring mistakes and entrapments. Below is a list of avoidable missteps in M&A transactions and their respective remedies.

1. GOING AT IT ALONE

What can get lost in these stories of M&As is the team of experts many executives depend on for areas such as M&A strategy, positioning, buyer identification, and negotiating and structuring the transaction to enable management to focus on running the company.

Lesson: M&A transactions are complex and require considerable expertise; seek expert assistance.

2. INWARD FOCUS

Maintaining an objective mindset during an M&A can be challenging. The result of failing to do so, however, is succumbing to heavily biased judgement, which is why boards and management must consider external market forces. A private company might never be concerned with public market movements until a public buyer is interested in acquiring them. Changes in a buyer's corporate leadership or strategy, buyer M&A activity, public market sentiment, and macroeconomic forces constantly alter deal dynamics.

Lesson: Expand your view to include external forces that need to align for your transaction to close; be prepared to refine and recalibrate your strategy.

3. FAILING TO CREATE A COMPETITIVE SALES PROCESS AND IDENTIFY ACQUISITION DRIVERS

Before commencing an M&A process, executives should conduct a broad market analysis to identify synergies and acquisition value drivers with potential buyers. Sellers should be armed with relevant financial parameters and strategic acquisition drivers, including revenue and profitability multiples, industry margins, and growth rates in order to estimate an expected transaction valuation. Most importantly, the seller should identify a number of buyers that could leverage the company's value proposition and quickly integrate for growth and profitability.

Lesson: Consider every financial/strategic player that stands to gain or lose from your company being acquired.

4. INADEQUATE UNDERSTANDING OF THE COMPETITIVE LANDSCAPE AND COMPARABLE TRANSACTIONS

Significant effort must be taken to grasp the particular dynamics of each small life sciences industry niche. Executives will commonly benchmark their technology against companies that play in different markets and expect the same valuation. Insofar as comparable transactions are concerned, market identification is crucial.

Lesson: Avoid futile discussions about valuation by disregarding transactions that are not relevant to your value proposition. If they are not a key competitor, do not benchmark yourself against them.

5. OBSESSIVELY FOCUSING ON FINANCIAL TERMS WHILE IGNORING THE PROBABILITY TO CLOSING

Executives are often overconfident about their chances of success with an M&A. However, when a multinational company offers a term sheet, they are seldom inclined to engage in extensive discussions about specific valuation metrics. As the buyer's BD team is likely strapped for resources, they will lose patience negotiating superfluities. It is imperative that management focus their time on closing instead of engaging in never-ending discussions.

Lesson: Time is the enemy of transactions; move with haste and focus on what is truly important.

6. BEING UNPREPARED FOR THE EXTENSIVE EFFORT AND TIME THE TRANSACTION WILL CONSUME

Executives should allocate appropriate resources and expect the M&A process to last six to eight months. If there are internal company issues – for instance, options plans or receivables – the complexity of the M&A process will be magnified. Compounding the challenge to resolving these issues is a management team preoccupied with closing. It is the seller that usually constricts the flow of information. Activating a key group of employees in your company can greatly shorten time to closing and showcase operational strength.

Lesson: Prepare your operations team accordingly and "button up" all outstanding governance issues — they will only fester and worsen with time and confirm to a buyer they are dealing with an amateur.

7. ALLOWING BIASES TO IMPACT DECISION MAKING

With M&A transactions, executives often rely on "rules of thumb" (heuristics) that may seem reasonable but lead to severe errors. They plan an M&A strategy haphazardly and make predictions about acquisition price and various other terms. Their point of view is heavily dependent upon the information available to them as well as their personal judgements based on individual experience.

Lesson: Accept that human error is rampant. Adopt a statistical mindset, and substitute human judgment and intuition with formal thinking.

8. FAILING TO PRESENT A CLEAR AND COMPELLING VALUE PROPOSITION AND STRATEGIC FIT WITH ACQUIRER

Management teams often inaccurately assume that corporate BD teams rigorously analyze each potential deal that comes to them. This belief, however, can cause otherwise value-enhancing transactions to never leave the runway. A clear and differentiated value proposition must be communicated to buyers from the initial point of contact. Sellers should take the time to formulate and articulate a strategic fit tailor-made to each potential buyer. The strongest letters of intent (LOI) are products of thoughtful strategic discussions centered on how an asset is better used in the hands of buyer.

Lesson: Identify your company's true value to its market and how its value is differentiated (and defensible) from competitors. Then, review each potential buyer separately and identify unique value enhancing synergies.

9. ABSENCE OF CREDIBLE FINANCIAL PROJECTIONS

Buyers spend considerable time evaluating a seller's current and projected financials and often employ valuation methodologies, such as the discounted cash flow (DCF), to assess value. A seller's unrealistic/unreasonable projections will adversely affect management's credibility and will create buyer distrust — the killer of all deals. Unique to private transactions, there is no such thing as the "right price" or fair market value of an asset; what a buyer pays is based on its views of the financial future value of the seller. Thus, the inputs into a DCF model to determine value will be different from buyer to buyer, and these are different from the view of the seller, who sees its company on a stand-alone basis.

Lesson: Ensure your financial projections are realistic and in line with market benchmarks. Allow for a valuation range.

10. NOT NEGOTIATING KEY TERMS EARLY IN THE PROCESS

A detailed LOI is likely to result in more favorable terms for the seller and will reduce the time to executing a definitive agreement. Once an LOI is executed, leverage migrates from seller to buyer because of the exclusivity provision that prohibits the seller from negotiating with other bidders. Some of the terms to be included in an LOI are price, structure (up-front cash, milestones, royalties), the calculation for price adjustments (working capital, cash-free, debt-free), amount and duration of escrow holdbacks, treatment of employees, representations and warranties, and conditions to closing. A seller must be clear, early on in M&A negotiations, about what the expectations are and what "third rails" to avoid.

Lesson: Choose early on in the process what key terms must be met for a deal to be consummated; communicate to buyers those terms, and do not waste valuable time negotiating less important issues. L

Dr. ODED BEN-JOSEPH is Managing Director at Outcome Capital, LLC.

THOMAS BUSBY is an Associate at Outcome Capital, LLC.

OUTCOME CAPITAL