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A CONVERSATION WITH PHILIP E. PFRANG

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As the National Healthcare & Life Sciences Industry Leader of Deloitte's M&A Transaction Services, Philip E. Pfrang has advised clients on more than 400 completed and proposed transactions and has extensive experience in cross-border and multinational deals. *Directorship* spoke with Pfrang about trends in the healthcare and life-sciences marketplace and his prognostications for M&A in the near term.

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The M&A marketplace has changed significantly in the past 12 months. How has this affected deal making and what types of deals are being completed?

The volume of transactions has slowed significantly and the deals that are getting done are smaller, less leveraged, and more complex. In early 2007, we were seeing private-equity deals in life sciences and healthcare valued at more than $10 billion, but there hasn't been a healthcare private-equity deal north of $3 billion to $4 billion since July of 2007.

What's putting the brakes on the market?

The credit crisis is clearly having an impact on financial buyers and is beginning to have an affect on strategic acquirers, who are seeing their credit lines tightening as well. In addition, many stock valuations of healthcare and life-sciences companies are depressed so strategic acquirers don't have the ability to write an equity check. It's simply too costly.

Why isn't more foreign investment being made?

The U.S. dollar has been extremely weak against most other major foreign currencies, and one would expect to see a significant volume of in-bound investment. However, we're beginning to see that the credit crunch and economic slow down are affecting foreign companies as well.

Would it be accurate to say the aging U.S population is an important driver of growth?

The growth rate in healthcare continues to outstrip growth in the overall economy. Given the demographic profile of the U.S., there is no reason to expect that the trend won't continue into the foreseeable future. Baby boomers are reaching retirement age, and the vast majority of healthcare expenditures occur after age 65. There are other factors that are causing healthcare to grow faster than the overall economy as well, such as the obesity epidemic and chronic illnesses related to that.

What advice do you offer to directors and board members as they consider M&A, and what questions should directors be asking of management?

The first piece of advice is to get involved in the M&A process sooner. We've seen many situations where the management team has spent significant resources with no input from the board. Directors should understand that potential transactions tend to develop a momentum all on their own and can have consequences regardless of whether the deal moves forward, which is why boards should be engaged from the beginning. Some of the key questions that should be asked are: Why is the company pursuing this particular opportunity? Does it fit within the company's strategy? Are there significant risks of execution? Transactions that are overly dependent on synergies, especially revenue synergies, have historically shown a significantly higher execution risk.

Why is it still important for companies to keep M&A on their radar during times of economic uncertainty?

Economic uncertainty or distress creates opportunities, and companies that may not have been receptive to a transaction absent those stress points may entertain an offer during a downturn. Some of the most successful transactions in history have occurred during times of economic distress. Downturns create risks and opportunities for everyone. Companies would be missing opportunities if they were to simply shut down their process for evaluating alternatives during such times.

What are some common deal breakers that officers and directors should be on the look out for?

Deal breakers come in every size and shape. It really depends on the sector and the value proposition of the deal. However, there are some good examples. Within healthcare, regulatory, and compliance issues are frequent culprits. If a significant regulatory or compliance issue is found, the deal is usually dead on arrival.

In some deals there might be issues with key customers or suppliers. Obviously the acquirer will want to speak to those groups as part of its due diligence process. Most sellers attempt to restrict those communications until the very end of the due diligence process. They don't want their key customers and suppliers to know until they're absolutely sure they have a deal. But if the retention of a key customer or supplier is essential to the deal, you can't wait until the end to confirm that. We have seen deals fall apart in the very final stages as a result of a negative reaction by key stakeholders to a proposed deal.

How can directors help ensure a good deal?

There are two things that are critical to help companies achieve the strategic objectives of their transactions. First, do the right deal. The deal should be consistent with the organization's strategy; companies shouldn't do a deal simply because the opportunity has presented itself. Second, execute the diligence and follow-through effectively.

The key to good due diligence is to focus on the value drivers. If the assumptions that drive value aren't valid, the deal will never succeed. From a follow-through perspective, we often see that companies are effective at identifying targets and getting deals done, but they drop the ball on the integration side.

Who has the upper hand in an acquisition—a private-equity investor or a strategic buyer?

It depends on the nature of the acquisition. Most strategic acquirers are public companies, or aspiring to be, so they may have to worry about the short-term pressures of Wall Street—meaning quarterly earnings reports. Private-equity investors (PEIs) have the ability to take a longer-term view which may give PEIs a competitive advantage in the right circumstances. A PEI can often take the time to complete the painful process of restructuring without the pressures of quarterly public reporting.

The major advantage for strategic buyers is often synergies. If a strategic buyer can achieve significant levels of synergies, it is often difficult for a PEI to be competitive on price. Many PEIs take a platform approach where they roll-up multiple companies within a particular sector. In that circumstance, liquidity is usually the key determinant in who wins and who loses.

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Debunking M&A Myths

Any attempt to short cut due diligence should raise red flags.
Here are some common statements Pfrang has heard about the M&A process.

"The financial statements were audited so we don't need to worry about financial due diligence."

Most of the issues that arise during due diligence may not necessarily indicate that there were accounting errors. We may find errors sometimes, but more often than not we uncover trends or other qualitative factors that impact valuation that don't arise from an accounting error. You need to understand the next level down and delve deeper.

"We're receiving an indemnification from the seller so we don't need to worry about due diligence."

Commonly, indemnifications are not constructed in a way that provides for a full compensation of lost value. Most indemnifications are balance sheet or liability oriented, not enterprise value oriented. An example would be to assume a liability that wasn't disclosed. Companies might get compensated for the amount of the liability, but probably won't get compensated for the full impact on the valuation. In addition, companies would probably have to sue the seller and prove damages before they could get compensated for anything.

"Acquisitions are the only deals that create value."

Divestitures are another strategy boards can employ to increase shareholder value. By reviewing its portfolio and culling non-core assets the company can focus on key growth areas.

"M&A is all about the final offer. If we offer top dollar, surely we'll succeed."

It's okay to pay a premium on a specific opportunity, as long as you know exactly how it contributes to your overall strategy. In all instances, however, directors need to have a realistic financial plan and understand that the seller of the target might not see price as the number one priority. For example, they may consider the integration and what happens to existing employees as the key issue. It's important to understand the target company's real needs.

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What is more important: acquisition or integration?

The two are inseparable. The ability to effectively integrate is something that we view as one of the key considerations that needs to be validated during the due diligence process. Even if a company does the right deal, if it doesn't follow through with integration, the deal may likely fail.

Is it true that the healthcare industry is recession proof?

The healthcare industry may be recession resistant, not recession proof. Healthcare and life sciences tend to do better in times of distress. However, the healthcare industry is dependent on regulatory changes and lawmakers in Washington. The government is the single largest payer for healthcare services and it is under tremendous pressure to rein in spending. As we have seen in the past, the government has the ability to have a dramatic impact on individual sectors within healthcare or even the industry as a whole.

What M&A trends do you expect in the healthcare and life-sciences sectors?

Any time you talk about trends in the healthcare and life-sciences sectors you should be aware that there are drivers specific to each sector.

In life sciences, the large pharmaceutical companies have generally been unable to fill the R&D pipeline to replace the blockbuster drugs due to go off patent in the next few years. Most of big pharma is focused on that pipeline so we're seeing a significant amount of M&A activity there. We're also seeing transactions involving drugs and therapies that are deeper into the development process, as well as diversification away from the prescription or consumer-based model into new markets such as animal health.

On the healthcare side, most people believe there is likely to be some belt tightening in Medicare and Medicaid and we continue to see providers and payers use acquisitions to create scale in an effort to improve efficiencies and position themselves to weather the storm of reductions in government spending.

What other issues should a board contemplating an acquisition in the next 12 months be considering?

Boards need to be thinking about legislative actions. In recent weeks, a presidential veto was overridden which suspended or deferred the reimbursement cuts for physicians and provided some relief to the durable medical equipment industry. These types of legislative changes can have huge affects on the industry. Boards need to constantly be thinking about how to react to legislation that will impact their companies.

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