



**The role of innovative and unfamiliar  
acquisitions in unlocking R&D  
productivity**

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## Foreword



This report on *'The role of innovative and unfamiliar acquisitions in unlocking R&D productivity'* builds on our findings from *'Unlocking R&D productivity'*.

Since 2010, our reports on *'Measuring the return from pharmaceutical innovation'* have tracked an overall decline in predicted returns from R&D investment. Nearly every year, average R&D costs have increased, and average forecast sales have decreased across the companies we have monitored, demonstrating the increasingly challenging R&D environment that biopharma companies are facing.

This report begins with a brief analysis of the different approaches biopharma companies have taken to improve R&D productivity and value, but the main focus is on one of these approaches – making small-to-medium size R&D-driven acquisitions, with a particular focus on 'innovative and unfamiliar deals' i.e. deals in which the acquired organisation had asset modalities, capabilities or therapeutic focus that are not areas in which the buyer has extensive expertise as companies attempt to augment their traditional sources of pipeline value with assets and technologies from business segments in which they do not currently have a presence.

We examine deal trends, the relationship between R&D productivity and R&D driven deals, the risks involved in an acquisition strategy and how these might be addressed to maximise value retention and sustainable advantage.

We hope you find this report of interest and we welcome any thoughts or feedback regarding its findings and conclusions.

A handwritten signature in black ink, appearing to read 'Colin Terry'. The signature is fluid and cursive.

**Colin Terry**

**Partner**

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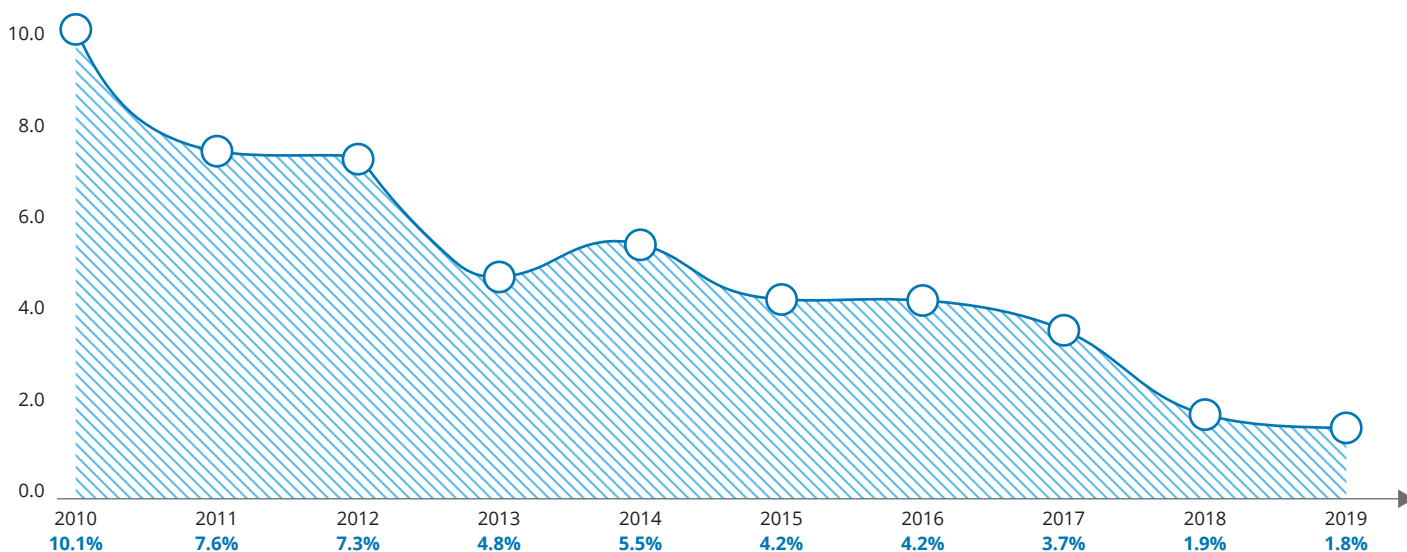
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# The search for R&D productivity in biopharma

R&D returns have fallen to the lowest level in ten years, driven by the cost to bring an asset to market increasing to record levels in 2019, whilst forecast peak sales per asset have more than halved since 2010.

Figure 1. R&D returns for large cap biopharma companies 2010-19



Source: Deloitte LLP, 2019, Measuring the return from pharmaceutical innovation

Each new product reaching the market is expected to provide revenues that justify the costs of development. In addition, companies seek to develop a portfolio of products in the late stage of the development pipeline, nearing commercial launch, in order to sustain profitability over the longer term.

For large biopharma companies, the financial returns from new products have fallen from about ten per cent in 2010 to less than two per cent in 2019 (see Figure 1).

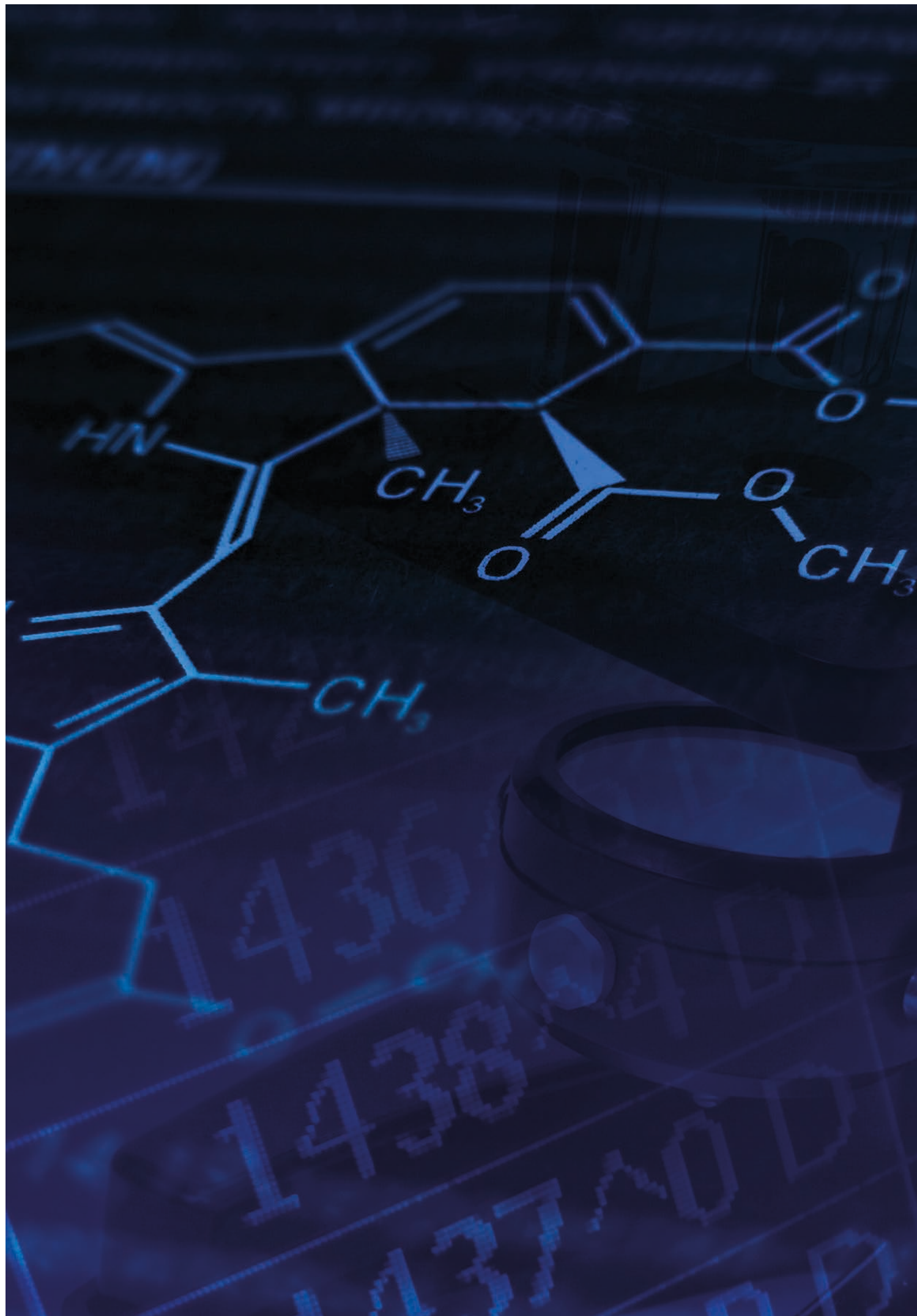
This decline is due largely to increasing costs of new product development and falling revenues over a product’s life. The typical cost of bringing a major new asset to market increased from \$1,188 million in 2010 to \$1,981 million in 2019, whereas forecast peak annual sales have fallen over the same period from \$816 million to \$376 million.

There a number of reasons for this reduced level of return, chief among which is the value lost through commercial portfolio not being replenished by new assets from development or licensing deals at a necessary rate. In addition to a lower number of late stage assets, drugs are increasingly being focussed on smaller patient populations (orphan drugs), patent cliffs are affecting revenue streams and costs are continuing to rise due to longer and more complex trials with greater regulatory conditions. These internal and external challenges superimpose to reduce the overall peak sales per asset.

The challenge for biopharma companies is to pursue innovative approaches to new product development that reverse the declining trend in financial returns, either by managing development costs or finding ways to improve revenues.

For large biopharma companies, the financial returns from new products have fallen from about ten per cent in 2010 to less than two per cent in 2019.

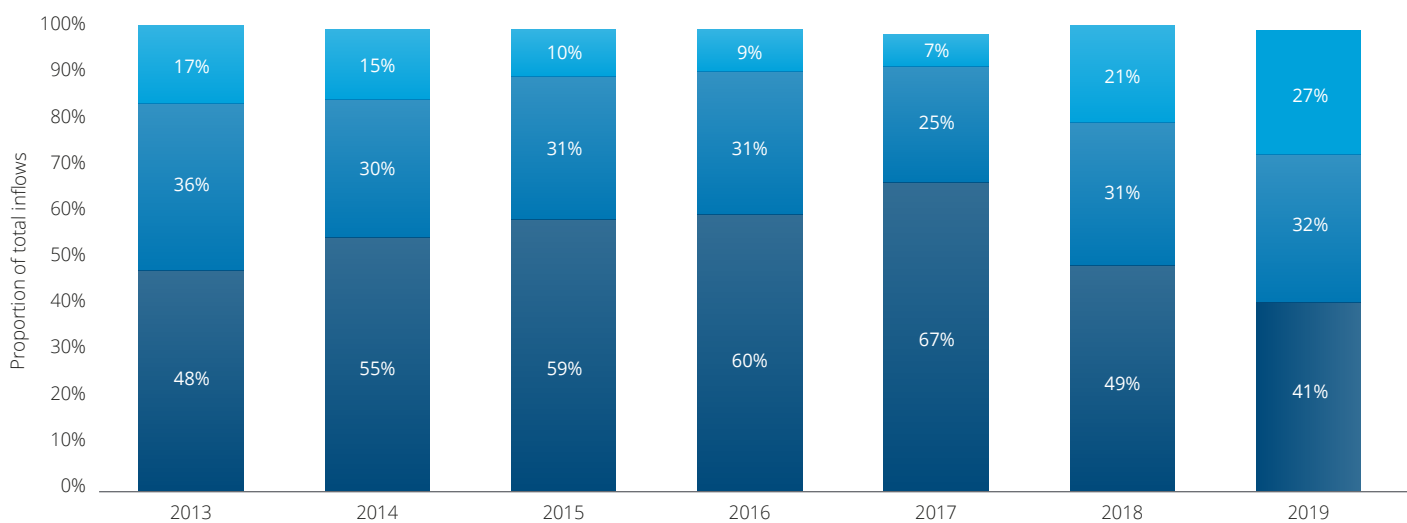




# M&A continues to play a significant role in shaping the R&D landscape

Our analysis helps to illustrate that M&A has always played a significant role in shaping the biopharma landscape. The industry has always invested a significant part of the cash generated into M&A, which in part feeds the R&D pipeline (the focus of this paper).

**Figure 2. M&A contributions to late-stage pipeline value**



■ Self-originated ■ Other ■ Acquisition

Source: Deloitte LLP, 2019. Note this is a combined figure for the original and extension cohorts  
 Note: 'Other' includes Joint venture, Co-development and In-licensing.

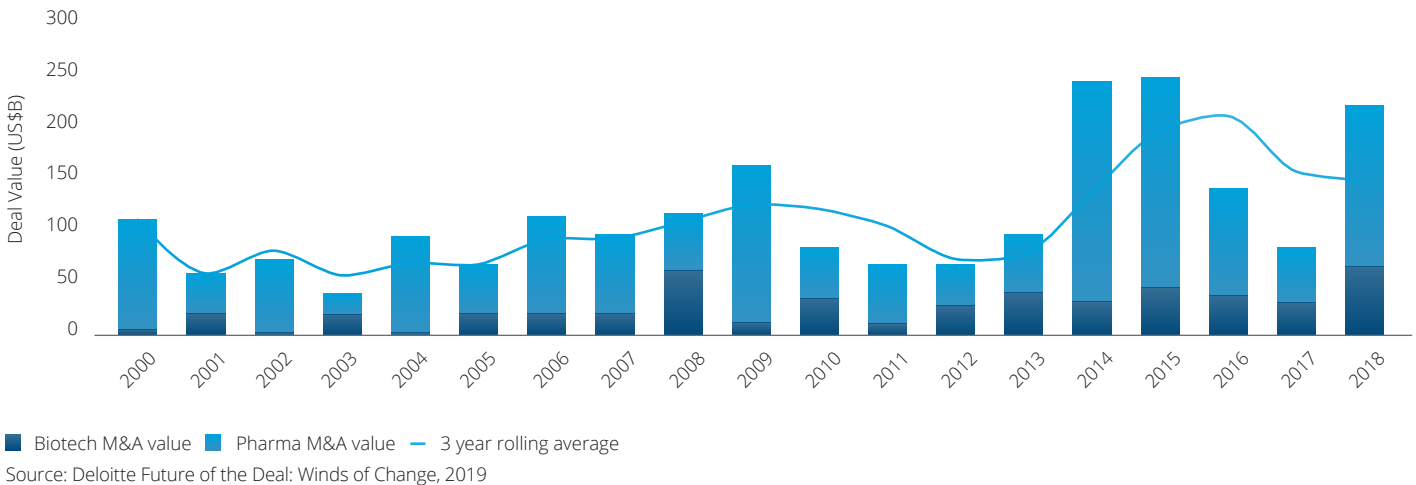
Analysis by Deloitte of 12 large-cap and four specialised biopharma companies found that the contribution of self-originated R&D to the total value of their late-stage development pipeline fell from 59 per cent in 2015 to 41 per cent, whereas the proportion contributed by R&D acquisitions increased from nine per cent to 27 per cent (see Figure 2). The reality of the current market environment requires M&A to bolster pharma companies' pipeline to fulfil current and future targets.

Self-originated (internal) R&D remains the most important contributor to late stage pipeline value. The relative contributions to late-stage pipeline value from other approaches vary from one year to the next. However the figures may suggest that R&D acquisitions are gaining in importance as an approach to developing a late-stage pipeline – a partial response to developments in their internal pipeline, as approvals are harder to achieve and failures in the pipeline need replacing to support market valuation.

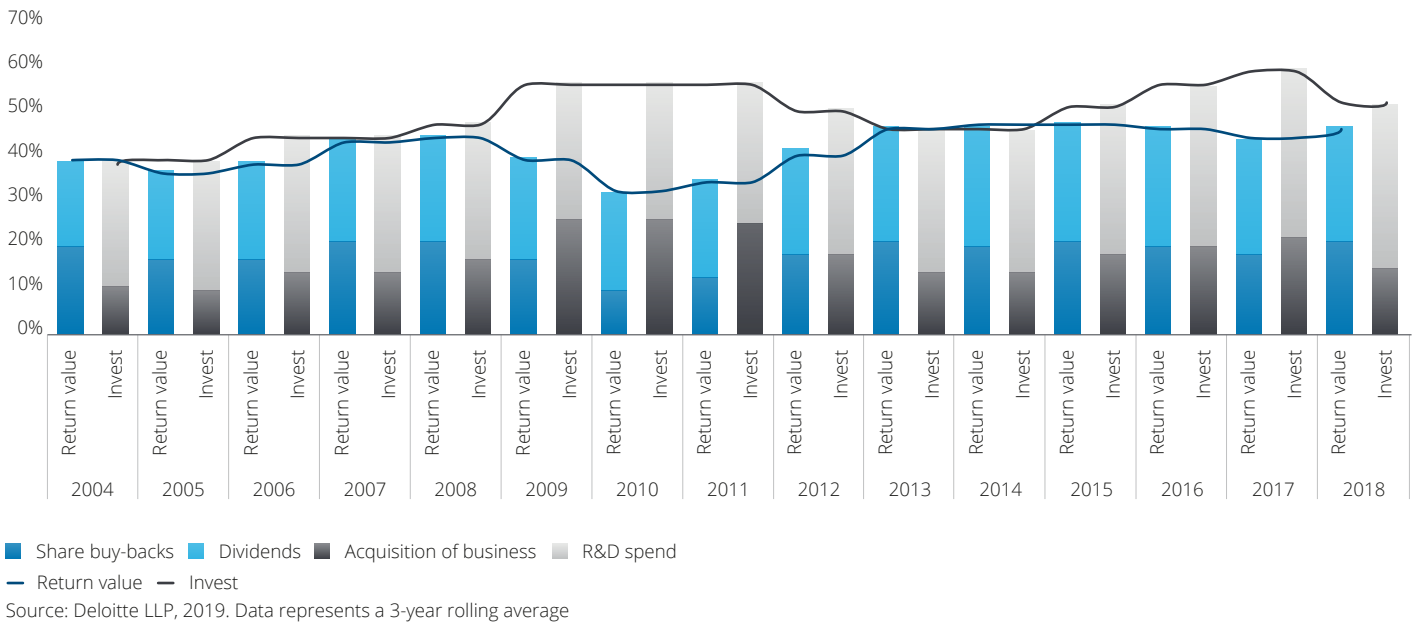
M&A increased markedly in 2014. By 2018, biopharma sector deal value reached \$222 billion, of which 71 per cent (\$156 billion) were pharma focussed (Figure 3).

The reality of the current market environment requires M&A to bolster pharma companies' pipeline to fulfil current and future targets.

**Figure 3. The total value invested in biopharma M&A deals has trended upwards**



**Figure 4. Relative proportions of value invested and returned across the group of 16 biopharma companies analysed**





After a period of reduced activity corporate cash is now flowing back into M&A, with investment options remaining more attractive to management than a pure return of cash to shareholders via share buy-backs or dividends, perhaps reflecting the availability of cheaper finance to support growth (Figure 4).

These archetypes to internal R&D are compared in more detail in Figure 5.



Figure 5. The analysis focusses on R&D-driven acquisitions and their potential to impact R&D productivity

	Partnering deals	R&D driven bolt-on acquisition	Mega-merger
 <p><b>Definition</b></p>	<ul style="list-style-type: none"> <li>Deal that does not result in a business combination from an accounting perspective; typically single asset or platform specific.</li> <li>Concerns about the ending of patent rights on existing products may be a reason for the drive towards innovative and unfamiliar and early stage deals which may yield longer-term potential, but they are not quick-fix approaches to boosting revenues.</li> </ul>	<ul style="list-style-type: none"> <li>Significant R&amp;D/pipeline element, possibly including commercial assets, but of a smaller size than the acquirer.</li> <li>Inevitably, there is a great deal of risk and uncertainty with R&amp;D-driven acquisitions, but we believe that this approach will remain an attractive option in the longer term of bolstering R&amp;D pipelines and revenue streams, and could improve R&amp;D productivity. Acquisitions may involve either horizontal or vertical integration.</li> </ul>	<ul style="list-style-type: none"> <li>Significant commercial element to transaction, often classified as &gt;\$10 billion.</li> <li>Intended to deliver commercial benefits by creating a larger portfolio of products, offsetting in the short term any declining revenues, and realising synergies (and cost reductions) in operations and the supply chain.</li> <li>However, although a mega-merger will increase market share, it may not improve R&amp;D productivity. Expected benefits from pipeline expansion are not always realised, and typically further investment is needed in development.</li> </ul>
 <p><b>Motivations</b></p>	<ul style="list-style-type: none"> <li>Additive where we know the space.</li> <li>Tentative/high risk exploration.</li> <li>Geographic strength differential.</li> <li>Capability strength differential.</li> <li>Part of a long term innovation engine.</li> </ul>	<ul style="list-style-type: none"> <li>Long term pipeline planning (5-10 years).</li> <li>Forecast mid-term decline in revenues.</li> <li>Entry to new TA/modality.</li> <li>Prevent competitor access.</li> <li>Provide complementary capabilities.</li> </ul>	<ul style="list-style-type: none"> <li>Offset immediate declining revenues.</li> <li>Operational and supply chain synergies.</li> <li>Ability to take on significant debt.</li> </ul>
	<p><b>Horizontal Integration</b> ←</p> <p>Horizontal integration enables the buyer to extend its activities into new therapy or disease areas, acquire new methods of treatment, or simply bolster its pipeline in areas where it already has focus.</p>		<p><b>Vertical Integration</b> →</p> <p>Vertical integration enables the buyer to extend its business into different stages in the R&amp;D value chain, for example by acquiring companies with analytics capabilities.</p>

The following sections of this report focus on just one of these approaches to pipeline development: R&D-driven acquisitions, and in particular ‘innovative and unfamiliar deals’ which take the acquirer into a new sub-sector of the market.

In our view, the pursuit of small-to-medium size R&D-driven acquisitions will play a key role in driving future productivity and overall corporate growth for large biopharma companies.

# Companies have invested £92bn in R&D-driven M&A since 2017

We analysed all R&D driven acquisitions between January 2017 and June 2019. While the analysis indicates (by deal value) M&A is being used to drive Therapeutic Area (“TA”) growth, we are seeing a high volume of Digital, New Modality and TA entry acquisitions.

Across the cohort of 12 large cap and four specialised biopharma companies we analysed their M&A activity by value, number and strategic focus, concentrating on R&D focussed transactions. See sidebar and Figure 6.

An analysis of R&D driven deals indicates that while biopharma firms use acquisitions as a way of accessing new TAs in which they do not currently develop, they have invested over three times as much in expanding their existing TA pipelines.

Innovative and unfamiliar acquisitions (TA entry, modality and digital deals) represented 66% of deals completed by number (26 out of 39) but only 47 per cent by value (\$43.5 billion out of \$91.8 billion). We believe that this reflects risk appetite: biopharma companies chose to make more lower-value bets on longer-term strategies to improve R&D productivity. We expect this trend to reverse as companies need to find creative ways to reduce R&D costs.

**Figure 6. R&D-driven acquisitions by value and number, January 2017 – June 2019 Q2, for the 16 biopharma companies analysed**

## TA Entry

**£11.8 billion**

Therapeutic area (TA) entry. This involves gaining access to a therapeutic area when the acquirer does not currently operate. It is therefore an ‘innovative and unfamiliar acquisition’. The rationale for this type of deal should be to extend operations into new areas where R&D productivity is high and here are good prospects for business growth.

## TA Expansion

**£48.3 billion**

Therapeutic area (TA) expansion. This involves the acquisition of one or more products in a therapeutic area or a modality where the acquirer already operates, for example in cancer treatments or cardiovascular diseases. The rationale for an acquisition of this type would be either to strengthen the buyer’s presence in its existing markets, or as a defensive measure to protect market position.



Across the cohort of 12 large cap and four specialised biopharma companies we analysed their M&A activity by value, number and strategic focus, concentrating on R&D focussed transactions.



### Digital

**£2.9 billion**

Digital. A digital acquisition involves buying a specialised data analytics firm. The rationale for this type of deal is to obtain a data analytics capability in order to identify trends in different TAs. Like TA entry and a modality acquisition, it is an ‘innovative and unfamiliar acquisition’.

### Modality

**£28.8 billion**

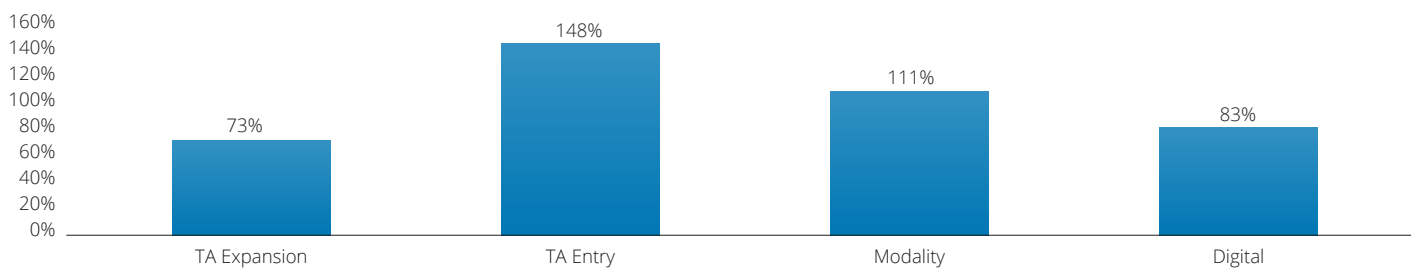
Modality. This involves the acquisition of assets or capabilities in a modality in which the acquirer does not have a market presence (or only a limited presence). Like TA entry, it is an ‘innovative and unfamiliar acquisition’, and the rationale for this type of deal is the same.

Our analysis considered a total of 39 deals across the 16 companies (comprising 6 Digital, 16 Modality, 13 TA Expansion and 4 TA Entry) over a two-year period. These were filtered using specified criteria:

1. Full acquisitions. Excludes joint ventures, partnerships, in-licensing, investment-based transactions.
2. Small-to-medium-size acquisitions. Excludes mega-mergers and deals driven primarily by the acquisition of commercial assets.
3. Companies engaged in human pharmaceutical research such as molecules and digital health assets. Excludes diagnostic/medtech, animal health.
4. Time horizon – deals completed from start of 2017 to June 2019.
5. Small-to-mid R&D driven acquisitions – exclusion of mega-merger acquisitions and those where the deal was primarily driven by access to commercial assets.
6. Full acquisition – exclusion of joint ventures, partnerships, in-licensing and investment-based transactions.
7. Type of product – companies engaged in human pharmaceutical research including molecules and digital health assets were in scope, with other business units e.g. consumer, diagnostic/med tech, and animal health excluded.

In order for shareholders to consider and accept an offer from big pharma, significant premiums are having to be paid relative to the trading share price 90 days prior to announcement.

Figure 7. Increase in share price over a 90 day period by deal type



■ 90 days prior to announcement date

Source: Deloitte analysis based on merger-market deals database

We analysed the 39 acquisitions to establish the size of bid premiums that buyers are paying for target companies. Most of the deals involved targets that were listed companies, so bid premiums were measured as the difference between the agreed bid price and the opening share price of the target 90 days prior to announcement. Average percentage premiums were calculated for each of the four types of deal (see Figure 7).

Our analysis shows that 90 days prior to the announcement of a confirmed deal, the largest premiums (in percentage terms) were being paid for TA entry (148%) and modality (111%) transactions, even though the risk is higher than for TA expansion deals. The high premiums are due mainly to a limited availability of quality assets, leading to increased competition. However, they also suggest that the acquirer expected to achieve an enhancement in value by at least the amount of the premium – otherwise there would be no financial rationale for the deal. The lower premiums for TA expansion deals may reflect that the value of R&D productivity improvements may be lower than for ‘innovative and unfamiliar’ deals or a need for follow on investment to support the target.

Premiums in general are being driven by a scarcity of high-quality acquisition targets: an increasing number of biotech companies are focusing on rare or orphan diseases, which require a smaller infrastructure to commercialise assets in development, so their requirement to sell or license out to Big Pharma is reducing. At the same time, biopharma companies have a lower number of self-originated assets that are being brought into clinical stage pipelines, and this has created a competitive pool of buyers seeking to supplement internally-developed assets with acquisitions.

Companies face significant risks in justifying high premiums linked to innovative and unfamiliar deals and longer-term bets. By making acquisitions in ‘new’ areas, the acquirer must commit to a research area that will require an allocation of R&D investment capital on top of the R&D allocation already made by the acquisition target. This is in parallel with ongoing investment required other research activities (c. 20-25% of R&D budgets<sup>1</sup>) which, with a lack of additional revenue to justify the increased allocation to investors, makes stretching out the available capital even harder.

The lower premiums for TA expansion deals may reflect that the value of R&D productivity improvements may be lower than for ‘innovative and unfamiliar’ deals or a need for follow on investment to support the target.

<sup>1</sup> Methodology: Measuring the return from pharmaceutical innovation 2018

# Assessing R&D productivity challenges is a key step...

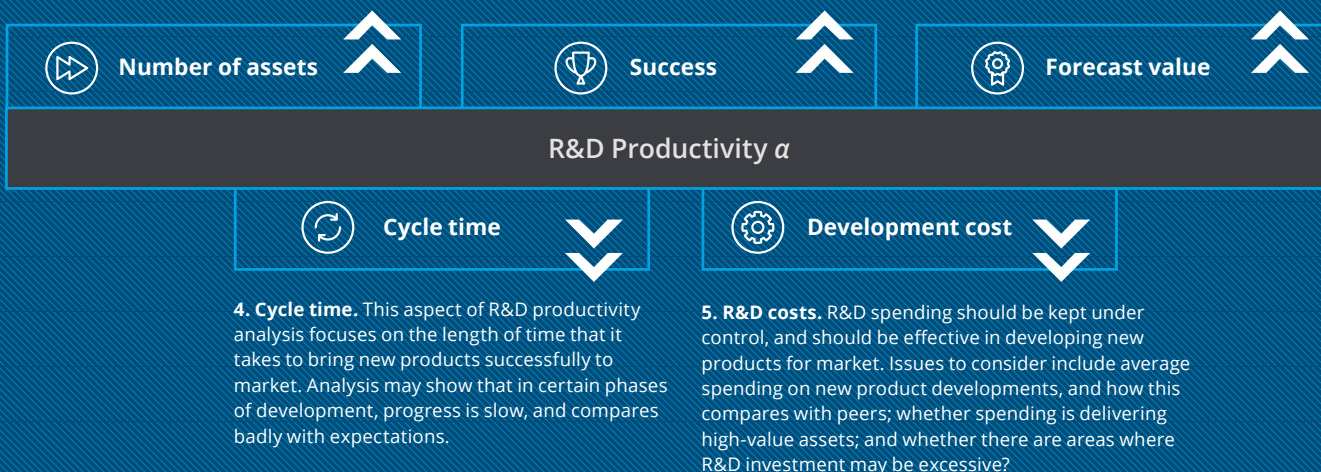
R&D productivity can be thought of as a factor of a number of variables covering value creation and efficiency, with all companies having areas of relative strength and weakness across each of these parameters.

**Figure 8. Diagnosing R&D productivity challenges**

**1. Number of assets.** This area of analysis focuses on whether the company has a sufficient number of products in the company's portfolio and development pipeline, and the 'shape' of the pipeline – i.e., is there a sufficient number of products at each stage of the development pipeline? If not, what are the 'gaps' and how should they be filled?

**2. Probability of technical and regulatory success (PTRS).** Clearly, the aim of R&D is to develop products that go successfully through technical and regulatory hurdles to a successful market launch. Productivity analysis should assess whether the rate of PTRS is sufficiently high. Are the right investment decisions being made, and does the PTRS seem to compare unfavourably with peers?

**3. Forecast value.** The focus here is on the value of assets in the development pipeline and the concentration of assets in particular therapy areas. Are products in the pipeline adding value or expected to add value? Is the portfolio concentration risk acceptable? Does the value of the portfolio compare unfavourably with peers?



Source: Deloitte LLP; equation adapted from Steven M. Paul, Daniel S. Mytelka, Christopher T. Dunwiddie et al. How to improve R&D productivity: the pharmaceutical industry's grand challenge. Nature Reviews Drug Discovery 9, 203-214 (March 2010)

There are five parameters for R&D productivity analysis, to establish whether improvements are required. Figure 8 outlines how companies can diagnose their own R&D productivity performance.

R&D productivity can therefore be seen as a combination of the financial returns achieved from each product brought to market, and also developing a portfolio or pipeline of new products at a late stage of development, which have a high probability of success in clinical trials and eventually reaching the market.



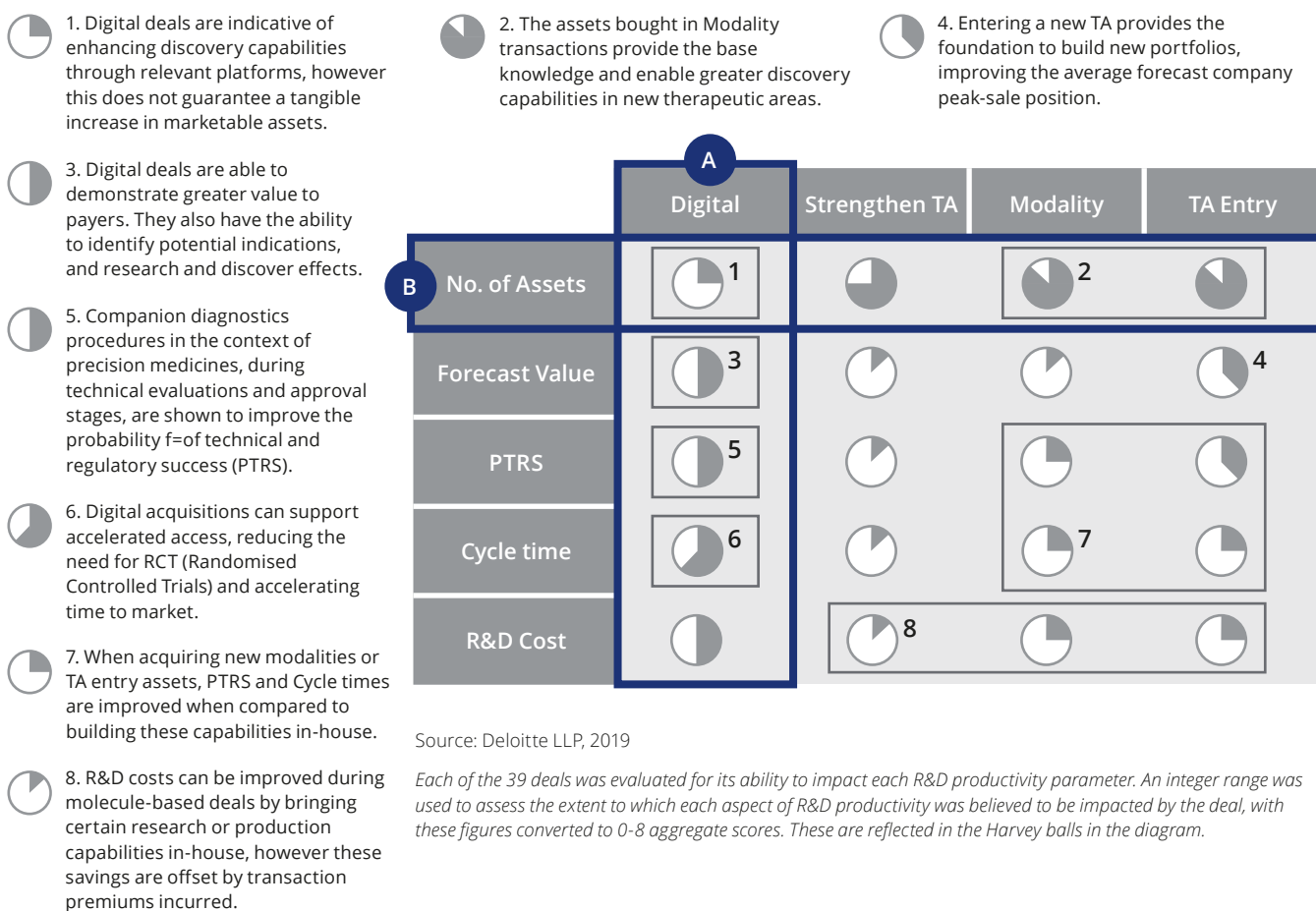




# ...in realising a successful deal strategy

Having understood the R&D productivity challenges specific to a given organisation, a more informed decision can be made on suitable targets to increase R&D productivity.

**Figure 9. Matching R&D-driven acquisitions with R&D productivity challenges**



We believe that by identifying existing R&D productivity challenges and matching these with the expected impact from each of the various types of R&D-driven acquisition, companies should be in a position to ensure that any proposed deal addresses a core need in the business. In other words, having understood the R&D productivity challenges, a more informed decision can be made on suitable acquisition targets. This will increase the likelihood that R&D productivity benefits and deal value can be realised. (Equally however, acquisitions can exacerbate the problems in achieving

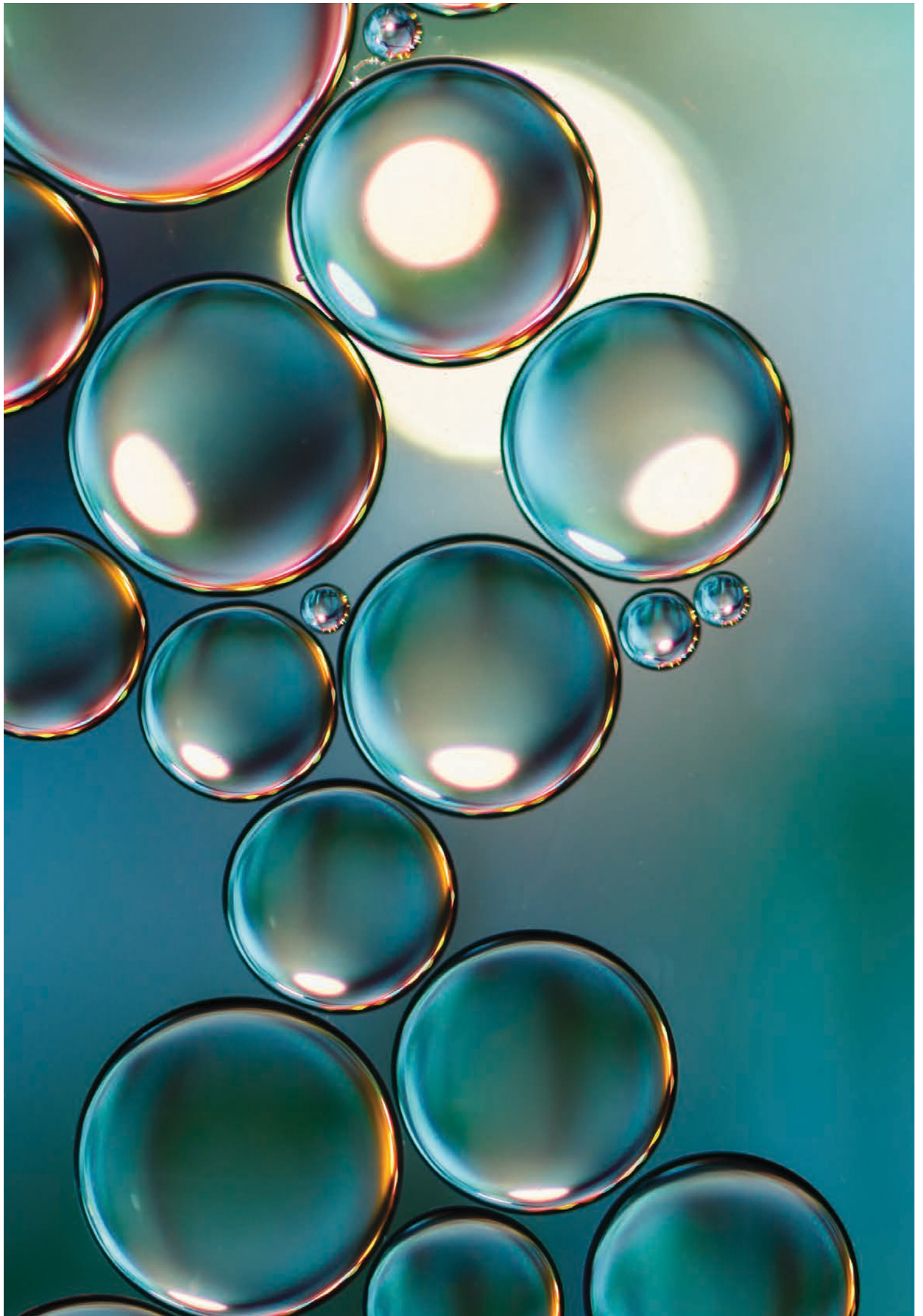
sustainable long-term returns if they are not in alignment with strategic aims.)

We assessed each of the 39 deals in our analysis based on their potential impact each of the five R&D productivity parameters. This revealed two macro observations:

A. Digital deals acquire capabilities for asset discovery and demonstrate advantages in accelerating R&D processes, leading to greater efficiency, more effective outcomes and reductions in costs.

B. As well as increasing overall portfolio size, molecular deals are more likely to have an impact on R&D productivity where mature capabilities are acquired, aiding further development efforts. Acquisitions of assets in an established TA are unlikely to have such an effect, but remain a valuable approach to helping cement a company's market position.

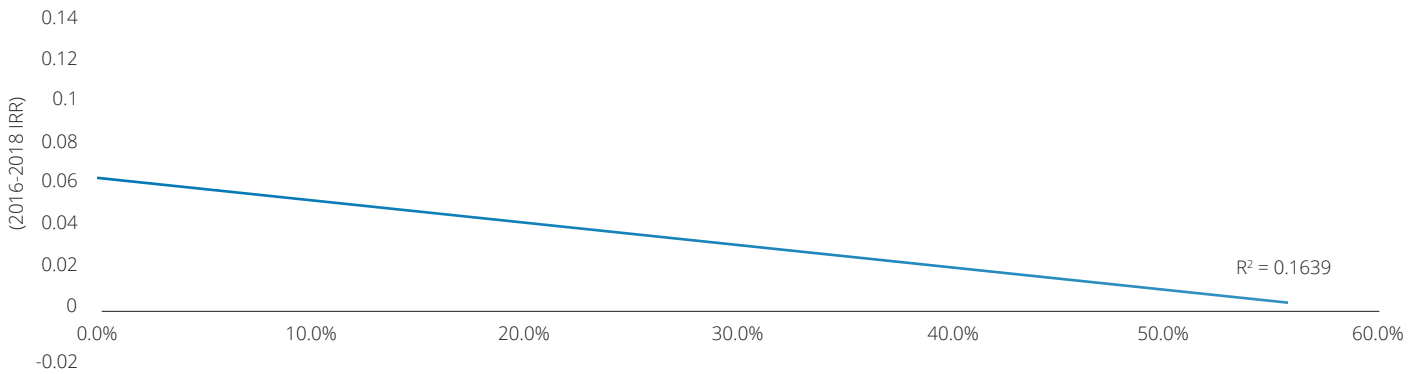
Other key insights from our assessment of the 39 deals are set out in Figure 9.



# There are challenges in conducting innovative and unfamiliar deals...

In acquiring an innovative and unfamiliar organisation, challenges and disruption may arise for an unprepared buyer, which risk destroying deal value and long-term R&D productivity.

**Figure 10. Correlation between returns and proportion of late-stage pipeline value from externally innovated assets**



% late stage pipeline value originating from company acquisitions  
 Source: Deloitte LLP, 2019

With an R&D-driven acquisition involving an innovative and unfamiliar deal (TA entry, modality, digital), the buyer is acquiring products in the development pipeline whose value has been created externally.

Our analysis of the 39 deals indicates there is a negative correlation between proportion of late-stage pipeline value that was originated elsewhere and projected returns from late-stage innovation. In other words, the greater the proportion of late-stage pipeline value originated externally, the lower the financial returns on R&D capital invested (see Figure 10).

This indicates that there are significant challenges in generating value successfully from external sources of innovation. Yet this seems inconsistent on the apparent reliance of companies on externally-innovated assets to drive much of their late-stage pipeline value.

This leads us to believe that while external innovation, and in particular R&D-driven acquisitions, present significant risks to R&D productivity, they can be part of the solution towards a sustainable portfolio provided that they are well conceived, pursued and integrated.

This indicates that there are significant challenges in generating value successfully from external sources of innovation.

We hypothesise that there are a number of underlying issues that may explain the poor returns from externally-sourced, late-stage pipeline products for acquisitions involving innovative and unfamiliar deals:

- **Wrong deal.** Did the deal properly address an R&D productivity challenge that needed a solution?
- **Scientific understanding.** Being an innovative and unfamiliar deal, has the science underpinning the acquired assets or technologies been properly understood?
- **Integration.** How should the acquired entity operate within the larger organisation? Should they be fully integrated or operate as a standalone so as avoid a culture clash? And do leadership understand the implications of any initial promises that were made about the extent of integration?
- **Talent and capabilities.** Have the right talents and capabilities been identified (and appropriately incentivised) that will deliver the expected productivity benefits from the deal?
- **Leadership and ownership.** Who will be responsible for the leadership of the acquired business and ensuring that the expected productivity benefits from the transaction are realised?

Companies often experience major problems with assimilating and integrating an acquired company, particularly when the target may require further investment to fully realise its potential for the buyer. There are likely to be problems involving differences in culture, making the process of successful integration both difficult and slow, with a risk that key employees in the target company may leave. There are also likely to be problems with integrating different governance models, and establishing responsibilities for decision-making in the newly-acquired business.

In view of the large premiums that are being paid for innovative and unfamiliar deals, there may be particular problems with R&D-driven acquisitions in justifying the prices that are paid and convincing shareholders on the value acquired. A further concern is that although the buyer is gaining access to a new sub-sector of the market by making an innovative and unfamiliar acquisition, it will also be necessary to ensure continued innovation post-acquisition and how this is further developed.

Companies often experience major problems with assimilating and integrating an acquired company, particularly when the target may require further investment to fully realise its potential for the buyer.



To improve value accretion and R&D productivity, R&D-driven acquisitions should have a clear rationale.

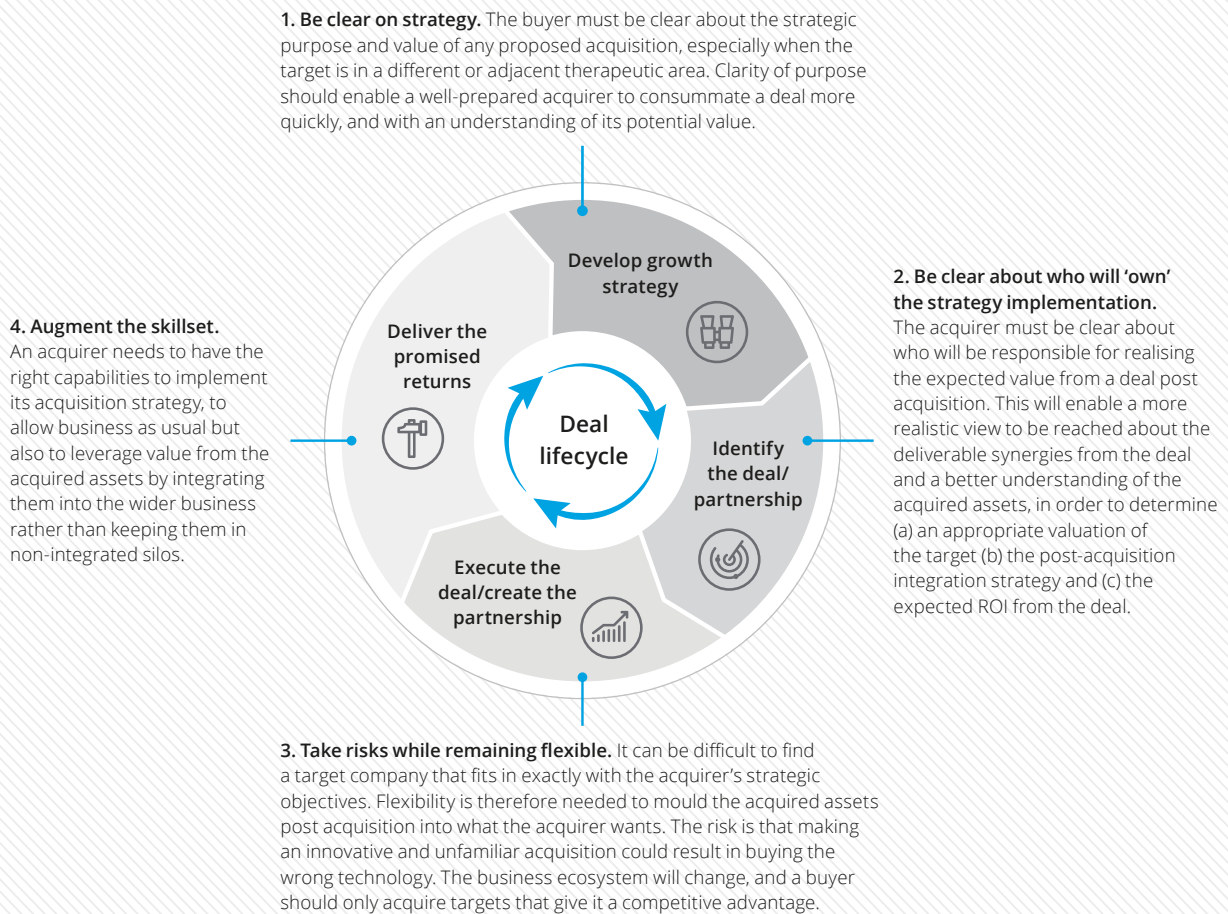
The negative correlation in Figure 10 is weak and not significant, and there are a number of steps that can be taken to ensure more value-accretive deals. Innovative and unfamiliar deals create both opportunities and challenges that need to be managed in order to realise the full deal potential. These challenges range from initial valuation, innovation

continuity, cultural change and convincing shareholders of the value, through to integrating governance models and optimising capabilities, and in some cases maintaining top-line revenue growth.

The opportunity is to increase R&D productivity and grow the business through well-managed diversification. Focusing deal strategy on addressing a genuine R&D productivity

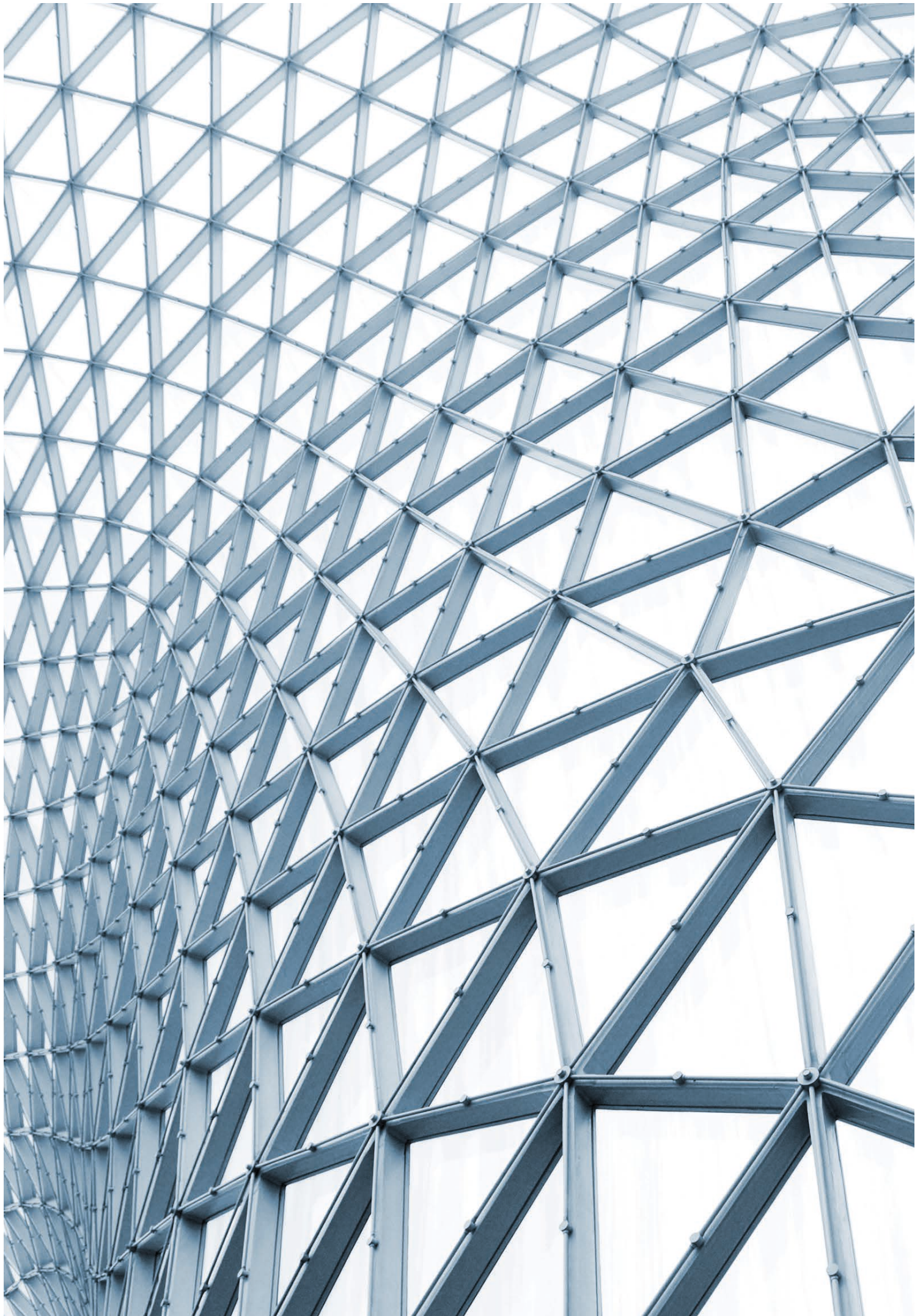
However, there are a number of measures that should be taken to reduce the deal risk (Figure 11).

Figure 11. Reducing the risk with innovative and unfamiliar R&D-driven acquisitions



Source: Deloitte LLP







# ...which if overcome, can still yield productivity benefits

Despite the challenges, acquisition remains an important route to access external innovation, as they have a number of strategic benefits in the search for a sustainable competitive advantage.

In the current market environment where deal sizes and premiums are increasing, but the number of deals is not, innovative and unfamiliar acquisitions could enable an organisation to improve R&D productivity and increase returns, in comparison to making TA expansion deals.

<p><b>Why execute a modality acquisition?</b></p>	<ol style="list-style-type: none"> <li>1 Open new approaches to targets. Complement existing therapeutic approaches</li> <li>2 Save the time and expense needed to build modality in-house, complement existing therapeutic approaches</li> <li>3 As a defensive measure to block competitors from accessing the source of innovation</li> </ol>	<p>Companies have been pursuing new therapeutic modalities, especially in emerging modalities such as anti-sense oligonucleotides and gene therapy. However, modality acquisitions also include deals where the acquirer does not have a significant foothold in a mature modality such as small molecules. Evaluating the science, especially where there is no prior experience in-house or understanding of the developmental and regulatory pitfalls, is a major challenge and can lead to deals failing to live up to potential.</p>
<p><b>Why execute a TA entry acquisition?</b></p>	<ol style="list-style-type: none"> <li>1 There are genuine scientific, capability and treatment adjacency overlaps with the acquirer's current portfolio that reduce the risk that the deal will fail to live up to potential</li> <li>2 There are genuine operational overlaps with current portfolio that reduce the risk or create economies of scale</li> <li>3 Target areas of high-growth potential or unmet clinical need may be accessible based on newly-acquired technology</li> </ol>	<p>Adjacencies are enhanced by maximising the degree of overlap between the acquirer's current portfolio and the target TA, with regard to aspects of target customers, technology, physician, pathology, or anatomy. This helps to optimise returns by improving the PTRS and maximising asset value.</p> <p>Where scale is a factor, careful consideration needs to be given to any anticipated economies of scale. Larger and more complex organisations do not deliver higher returns, and the acquirer needs to determine how the expanded portfolio will be governed efficiently. Areas of high-growth or unmet need are likely to attract interest from many competitors, so speed to securing a deal and/or best-in-class will be very important.</p>
<p><b>Why execute a digital acquisition?</b></p>	<ol style="list-style-type: none"> <li>1 Rival companies may restrict access to capabilities and use their position to drive a competitive advantage</li> <li>2 Prioritise molecular acquisitions by being a first mover and compete in a congested external innovation environment</li> <li>3 CxOs will acquire greater influence and extract greater profit balance, in an industry already experiencing declining returns</li> </ol>	<p>While the link to R&amp;D productivity is strong for molecular deals, it is not as clear-cut regarding the nature of 'disruptive' digital acquisitions. The challenges become more acute when considering what such deals might disrupt – the market, or as a consequence, the acquiring company itself.</p>

# We believe the industry will continue to drive further activity

## Are companies prepared to take full advantage?

With increasing pressure on revenues due to a decline in R&D productivity, acquisitions will continue to be a key lever for driving innovation, returns on investment and late-stage value. To judge by the number of deals announced in early 2019, the frequency of acquisitions is expected to continue in future. With deal premiums showing no signs of reducing (due to cheap access to capital and increasing demand for differentiated assets), investments in inorganic growth will need strong support from business leadership, to grow the acquired businesses and derive value over the longer term.

Regardless of being molecular or digital-based and the associated challenges these acquisitions may incur, there are good strategic reasons to pursue innovative and unfamiliar deals. Ultimately acquisitions should fit in with the broader corporate strategy of building distinct long-term capabilities in R&D. The structure and management of deals will determine the extent of the strategic, operational and financial benefits delivered going forwards, but R&D-driven acquisitions are no longer a quick fix for biopharma businesses trying to bolster their R&D pipelines.

Ultimately acquisitions should fit in with the broader corporate strategy of building distinct long-term capabilities in R&D.

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