M&A in Pharma manufacturing

The Pharma industry's transformation affects not only drug development and marketing, but also and increasingly so manufacturing. Changing regulatory frameworks, cost pressure, and an efficiency gap compared to other industries will lead to a fundamental reshaping of the manufacturing networks (in-house and outsourced) in the next few years, mainly through M&A.

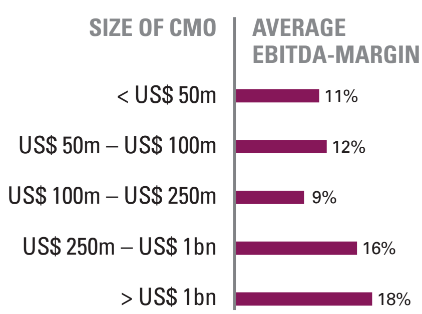
Fundamental changes ahead

What is to be expected? Pharma manufacturing shares fundamental features with the automotive industry. Both are large, complex and heavily regulated industries with multilayered value chains. In the automotive industry, car manufacturers had to cope with ever more stringent environmental regulations. As a result, car manufacturers and suppliers were forced to innovate, leading to leaps in fuel efficiency technologies. Other noticeable outcomes include consolidation and a broader scope of outsourcing or collaboration. Surprisingly, today, many suppliers are more profitable than some brand owners: Hyundai Mobis, Continental or Bosch have EBIT margins between 6% and 10% and ROCEs between 12% and 20%; leaving no profitability gap with the top car manufacturers (e.g. BMW). Thus, the maturation rearrangement of the manufacturing value chain led to a redistribution of the value captured.
In Pharma manufacturing, we observe trends which may lead to a similar result. First, there is an increasing consolidation pressure among the contract manufacturing organizations (CMOs). Second, outsourcing by Big Pharma increasingly involves selling own manufacturing sites to CMOs to operate them.

In a fragmented CMO market…

While contract manufacturing may appear to be a reasonably profitable business, there are large variations (see figure 1). The large CMOs generate substantial margins. Catalent for example has built a very strong position in advanced technologies (softgel, ODT) and delivers an attractive 20% EBITDA. Smaller CMOs, many of them local and without technological specialization, often do not generate enough profit to cover necessary investments. They are increasingly exposed to changes in customers expectations and in the regulatory environment (serialization, upgrade of ERP systems). Thus, many of the CMOs with less than US$ 25m revenues will disappear in the mid-term.
In a still fragmented market (see figure 2), there are few truly global players, but globalization is under way. Western European CMOs typically operate close to their historic base. To some extent they are looking at relocating some of their business to Central or Eastern Europe to offer a low cost base for commoditized services such as manual packaging. Increasingly, European CMOs aim at setting up operations in North America, preferably in the USA. CMOs based in emerging markets have aso become active in expanding geographically to Europe or to the USA.

FIGURE 1



Source: IMAP research.

… maturation forces to differentiate

Such a market structure – not truly global, large spread in profitability and size – is predictive for consolidation. Leading CMOs are developing acquisition or differentiation strategies, based on three pillars: reinforcing their customer base, selectively expanding their geographic reach and broadening their capabilities (technology, services and development). Recipharm's acquisition of Corvette in 2014 is a good illustration: gaining access to a new customer base with little overlap, acquiring a strong geographical presence in Italy with experience serving emerging markets, and strengthening lyophilization capabilities. Mid-sized CMOs like Aenova, Corden Pharma, Delpharm or Fareva energetically expand this way. Other mid-sized players aim at building strong positions in technical niches. Siegfried's acquisition of Pharma Hameln, for instance, makes them a globally leading service provider of sterile filling of injectables.

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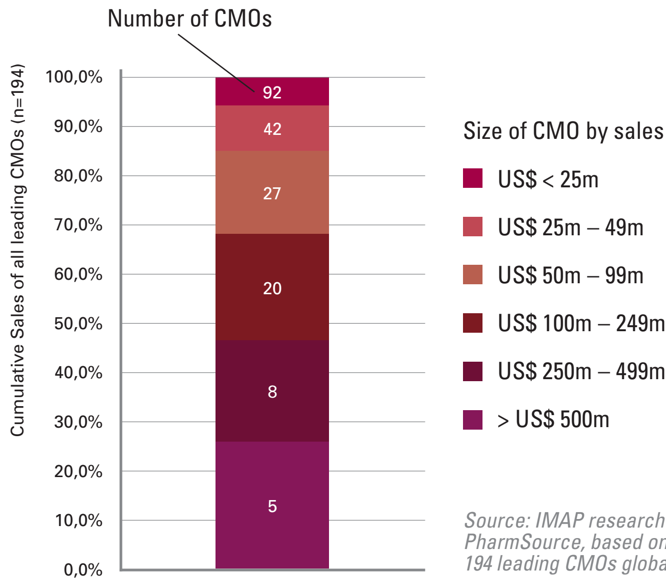
FIGURE 2 **FRAGMENTATION OF THE CMO MARKET**



Source: IMAP research / PharmSource, based on 194 leading CMOs globally.

The perspective of Pharma companies

Consolidation has left many large Pharma companies with sprawling, inefficient manufacturing networks. One key step for the networks' rationalization is the sale of operating plants. Unfortunately, these disposals are often treated as real estate transactions, not as sale of an ongoing business system intertwined with the seller's strategy. On the other hand, sellers' valuation expectations reflect the value as a "fit for purpose" business asset. This misalignment of M&A approach and financial goals leads to unsatisfactory results, or to the premature termination of the selling process.

Stakeholder alignment

At the outset of a sale of an operating plant, senior management needs to be aligned to realistic expectations. The result of a disposal is a combination of the price paid by the acquirer, the manufacturing agreement (costs and terms of manufacturing), and the supply certainty (business continuity, compliance, etc.) provided by the buyer. These three dimensions typically affect different line managers at the seller who have to be aligned.
In the past, Pharma companies were too often forced to refinance the acquirers of their plants. They now pay much more attention to the overall profile of candidate buyers (quality record, financial stability). CMOs, on the other side, had to learn hard lessons, ending with loss-making sites due to unrealistic expectations regarding new business, performance or cultural improvements and underestimated capital investment needs. We observe that acquisition prices for plants rather decrease than increase as a consequence.

Deal value is one parameter only

Transaction prices have to be assessed independently from historic investments in the plant. Obviously, there is a trade-off between the transaction price and future cost savings for the seller: lower manufacturing costs convert to a lower acquisition price. Our experience is that CMOs are relatively flexible to adjust the terms, applying a relatively transparent mechanism, which opens interesting opportunities to optimize the value for both sellers and buyers. Less obvious are the trade-offs between shorter duration of the manufacturing agreement and the acquisition price for the site. By co-developing an investment and business plan, buyers and sellers can also make this interdependence transparent and find mutually satisfactory solutions.

Outlook

We believe that the maturation of the CMO market and the ongoing pruning of the manufacturing network of Pharma companies will lead to a steady flow of transactions. They need to be shaped as long-term partnerships, similarly to some of the strategic alliances between Pharma companies and CROs. Scale and operational excellence combined with technical specialties may enable CMOs to capture an increasingly large part of the value, leading to a similar end-game as observed in the automotive industry today.

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