Merger and Acquisition Trends in the Animal Health Industry: When the going gets tough, the tough go shopping.

The perception on recent trends in M&A activity in the Animal Health industry:

Ever increasing deal tempo
Globalisation
Consolidation

Does the FPL view of the actual current and future activity agree with this?
Broadly speaking, yes but with some issues over the third of the above points. To take each point in turn:

Ever increasing deal tempo – **yes** - established trend continues with Qtrs 1-3 of 1998 keeping pace with an upward trend in activity and 1998 destined to be a record year for number of deals (if not $ quantum) if level of activity is maintained in final quarter

	1993	1994	1995	1996	1997	1998 (3 Qtrs)	1998 (full year est)
M&A Deals	17	17	24	21	28	25	33

(Source: Animal Pharm)

The number of strategic (rather than pure distribution) joint ventures is also on the increase, but at a substantially lower number than M&A deals

	1996	1997	1998 (3 Qtrs)
JVs	7	11	13
M&A Deals	21	28	25

(Source: Animal Pharm)

Globalisation – **yes** – if, for example, you look at the deals that have been done over the last three years you see very few that are wholly domestic to a national market:

	1996	1997	1998 (3 Qtrs)
M&A Deals	21	28	25
Wholly domestic	7	9	8

(Source: Animal Pharm)

Indeed, the dominant trends that FPL sees as increasingly driving M&A activity in the AH sector are most certainly pan-national: access to emerging markets and technology / products. Return to these factors later.

Consolidation – **yes, to a degree** – Why this view? There have undoubtedly been major changes in the identify of, and in the relative

positions of, companies within the *Animal Pharm's* annual listing of the industry's Top 20, all of which has been caused by the extensive M&A activity within the industry [i.e. Pfizer / SKBAH, Rhone Poulenc (Rhone Merieux) and Merck Animal Health divisions merger to form Merial, Mallinckrodt Vet / Schering Plough Animal Health, AHP (Fort Dodge) / Solvay to name the four most recent high level "consolidating" transactions].

However, and this is where our caution with endorsing the notion of "consolidation" wholeheartedly comes in, despite the number and scale of deals in the AH industry, the amalgamated market shares of the largest companies in the industry over the last three years have been essentially static (***slide 6***):

	1995	**1996**	**1997**
World Wide Market Total ($m)	15850	17421	17804
Top 20 Coys ($m)	10505	11183	12179
Top 20 Coys (%)	**66.3**	**64.2**	**68.4**
Top 10 Coys ($m)	8075	8600	9312
Top 10 Coys (%)	**50.9**	**49.4**	**52.3**
Top 3 Coys ($m)	3890	4165	4390
Top 3 Coys (%)	**24.5**	**24.0**	**24.7**

(Sources: Vivash-Jones International, Animal Pharm)

Unless something dramatic happens in the next two months, we expect the same proportional aggregate market shares will be the case for 1998.

The FPL conclusions to situation? First need to look at general industry conditions:

Low market growth [2.5% in 1997, a good year for general economic conditions. Reasonable to expect things to be at most the same in 98, given general economic turndown, esp. especially in emerging markets (SE Asia) which were generating most of what growth there was];

Lot of maturity in main geographical and product markets; and

Ever-increasing pressure on margins for main products (e.g. bulk products for agricultural sector), driven primarily by:

Increasing competition in the ethical markets; and

Expiry of patents on key products and the concomitant rise in generic competition.

Overall FPL conclusion from review of current situation – companies are having to run increasingly hard (in M&A terms) to maintain or improve their relative industry positions. Organic development in this type of market

environment is not capable of delivering the sort of growth that produces significant changes in industry ranking. There are and have recently been, for instance, very few big products – exceptions, such as flea control, are notable for their scarcity.

Future M&A trends patterns:

Dominant drivers for M&A (already seeing, will continue to grow in importance):

Geographic – companies buying their way into emerging markets (hit the ground running);

Technology / product acquisitions - need to energise pipeline, reduce risk and to dominate niches;

Examples: Heska's M&A activity in 1997: Made 4 acquisitions – 2 targets with strong geographical presences (Bloxham Laboratories in the UK and CMG in Switzerland) ; and 2 technology targets (Astarix Institute and Center Laboratories). 1998 examples include Bayer's acquisitions of SanVet (geographical, South Africa) and Microtek (niche/technology); Grampian's acquisition of Cobequid (niche / technology). Note the international aspect of nearly all of these transactions.

Scale – need to gain sufficient critical mass to afford the R&D spending to get on the virtuous upward spiral of more R&D funding–better products-higher profits-more R&D funding etc.

M&A will continue to be the dominant transaction modality. It is possible in theory to fulfill the three drivers mentioned above through JVs and distribution deals but empirical evidence and anecdotal evidence suggests that the use of these types of arrangement isn't likely to overtake the number of M&A deals, or even desirable from a strategic point of view (despite the obvious reductions in risk and commitment that these other modalities require). Most companies who have the means to commit to substantial JV projects want the control over their investment that (at least majority) ownership of manufacturing and distribution provides.

Mega-deals: there will be a very few more mega deals;

Prospective Industry model – drawing on the analysis above and our own experience of working within the Animal Health industry, coupled with FPL's experience in the wider pharma / biotech industries, it is not too fanciful to predict the development of a three-tier industry model in the international Animal Health industry:

1st Tier - Small number of huge companies – wide coverage with both products and geographic markets (distribution of both their own products and those of the 3rd tier companies in markets where the 3rd tier companies have weaker representation)

2nd Tier – Companies with developing or dominant positions in either particular product categories (e.g. Heska in companion animals), niche sectors (e.g. Grampian in aquaculture) or geographic markets (NuFarm in Australia and NZ).

3rd Tier – Technology / R&D companies. Probably the most provocative element of this 3 tier structure, given the economic pressures in and around the AH industry working against AH biotech (vs human health): smaller market size, lower margins, much smaller investment community. However, increasing need of larger companys for exogenous technology and product development – "the three most important things in this business are product, product, product" - to engergise mature and static market.

The FPL view of the place of M&A activity within this prospective model and, more generally, within the near to medium term future of Animal Health industry?

Our overall conclusion is that there is plenty of scope for continuing M&A activity, with (Slide):

1st and 2nd tier companies acquiring or merging with each other; and

1st and 2nd tier companies both acquiring 3rd tier companies and licensing technologies / products from 3rd tier companies.

However, FPL also believes that "independent life" will continue to exist for innovative Animal Health companies which have well-established and respected R&D capabilities and rounded product portfolios generating high margins relative to the overall AH industry. Good examples of those companies today (but not necessarily tomorrow) are Intervet and Elanco on the therapeutic side and Idexx on the diagnostic side.

Putting away the crystal ball…

Clearly acquisitions are going to continue to be a dominant feature of the AH industry. If my comments to date have been in any way persuasive, you are probably thinking, even now, on who you should acquire. However, this is merely the beginning of your problems and I would like to take a little time now to set out some of the issues that have to be addressed when entering into the acquisition process.

The first group of issues that a company needs to address before commencing on the acquisition trail, and one that is most often overlooked, is:

I. "KNOW THYSELF"; SOME IMPORTANT SELF ASSESSMENT ELEMENTS FOR AN ACQUIRER

A. Do we (your company) have the necessary internal resources to do this deal (including the assistance of external advisers such as bankers, lawyers, accountants' etc.)? Factors include:
    - Leadership
    - Manpower (availability and skill sets)
    - Data production, handling and dissemination

B. Assuming that a transaction idea originates from a Business Development department / responsible individual or divisional origin, can consensus be achieved across the various critical stakeholder groups, such as (slide):
    - Senior divisional and functional groups
    - Board of Directors
    - Major investors

C. Operating fit. What do we have? How do we want to develop what we have (if at all)? How would an acquisition impact on / fit with what we have? These questions can be applied to numerous functions or factors within an organisation:
    - Products
    - Technology / R&D
    - Manufacturing
    - Sales and marketing
    - Corporate culture
    - Management
    - Public and market perceptions

The broad aim of such self-assessment is to try and avoid at as early a stage as possible, horrible mismatches of ambition and reality!

So now, hopefully, we are in a position to marry the strategic vision with a full understanding of where we are at internally. The next step is:

II. SETTING REALISTIC – AND USEFUL – GOALS FOR ACQUISITIONS

Let us list specific objectives, that ideally are linked to the Acquirer's self assessment:

A. Technology/R&D Capability

Products in an R+D pipeline to fill a hole in the Acquirer's development cycle

Acquisition of enabling technology to speed up a manufacturing process or a discovery process (in the pharmaceutical world, an example is Glaxo/ Affymax)

B. Manufacturing Capacity

Particularly if very specialised (like certain vaccine processes)

Domestic plants - that operate at lower cost or higher environmental/regulatory compliance

Foreign plants, located near key markets

Access to rare raw materials or specialised compounds

C. Financial

Access to Target's cash or shareholder base

Combination of Acquiror and Target to have less earnings volatility

The combined company to have higher relative earnings (i.e. bigger EPS) - even after goodwill write-offs are taken into account.

Larger scale will allow (a) cost savings by elimination of redundant functions (like Glaxo-Wellcome or Roche-Syntex), and (b) other benefits that are industry specific such as, better cash flow from the combined revenue streams to support a relatively less costly and more affordable R&D effort (as % of total sales) – the importance of "scale" that we highlighted earlier.

Sweep-up of a majority ownership position where significant minority interests (held by Venture Capitalists, institutional investors or possibly competitive industrialists) may compromise the integrity or going forward strategy of the Target

Similarly, purchase of a Target to avoid potential damaging litigation, most likely to be in the area of patents or distribution arrangements

D. Market Position/Structure

Horizontal deals widen the geographic presence and market share and/or strengthen the Acquiror's product offerings on a portfolio basis (like the recent acquisition by Intervet of Veterinaria for its position in the Swiss geographic market, or the acquisition by Kemira Kemi of feed phosphate products from BASF)

Vertical deals get closer to customers or suppliers or distribution channels (like the Finivet acquisition of the French veterinary distributor Tregorvet)

Diversification of product portfolio

Acceleration of time-to-market for products

Achieve "near-monopoly" status

Entry into difficult-to-penetrate local markets where any other sort of arrangement, such as a sales agreement, would have produced unacceptable lack of control

II. Buyer Beware = Don't be too keen

However, there are some negatives inherent in the Acquisition game, which factors must be taken into account when establishing the goals:

a) There is a feeling, as expounded by Sean Lance, a former Executive Director of Glaxo Wellcome (in an interview in April 1997 in Pharmaceutical Business News) that "mere size may inhibit success"……implicit is the threat of disruption to ongoing R&D and to commercial operations, the absorption/distraction of management in the Acquisition itself, and the post-transaction trauma of integration.

b) The non-achievement of "geographic market dominance" or "product dominance" or "therapeutic category dominance"……..leaving the Acquiror either vulnerable or needing to do even more Acquisitions (as Kabi did with several small national pharmas before "merging" with Pharmacia, then buying Carlo Erba and, not finally, combining with Upjohn to create P&U). Occasionally an acquisition that is seen unfavourably by the market can render the would-be acquiror itself vulnerable to a takeover by an even more aggressive and/or larger predator (viz, telephone company wars of 1995-1996).

c) The lack of compelling necessity to buy something at all: Reed Maurer, writing in October 1995, makes a good case for Japanese abstinence from the Acquisition feasts - "access" (to such requisite business factors as external markets and intellectual or financial resources) will still be feasible

via the other structures, such as Marketing Agreements or R&D/Corporate Partnering collaborations, that we have discussed.

d) Over-riding point: Acquisition is not a substitute of innovation.

IV. A VERY BASIC PRIMER ON SELECTION CRITERIA FOR ACQUISITION TARGETS

A. PICK THE RIGHT SIZES OF TARGET

1. Sales

2. Employee Levels

3. Profits, if the Target is an operating company; R&D spend, if it is still an R&D company

4. Market Value, if quoted; Invested Capital, if unquoted… as these are markers for transaction value.

B. PICK THE APPROPRIATE LOCATION FOR THE TARGET

1. Single national market, if only local access needed

2. Regional business, if broader geographic access needed

3. No particular geographic slant, if your goal is the management team or technology of the Target

4. Ease of getting a deal done: for instance, the UK is a lot easier as an Acquisition venue than Germany, Italy more amenable than Spain, Europe more than Asia etc.

C. GET THE PRODUCT OR TECHNOLOGY FIT RIGHT

1. Verify the complementarity, if seeking to deepen the product line, market coverage, or R&D base of the Acquiror.

2. Verify the supplementarity, if seeking to broaden the product line, market coverage, or R&D base of the Acquiror.

3. Verify by discreet enquiry (with consultants or your own sales people) how the Target is viewed in the marketplace by its customers, actual or expected.

4. Look at the Intellectual Property position to determine whether the Target's patent or trademark estate creates value or confers benefits against competitors in the same field.

D. LOOK CAREFULLY AT KEY OPERATING FACTORS OF TARGET

1. How many sales people are there; what agency-like external distribution arrangements exist; and how do the Target's sales channels (retail or wholesale, research or industrial/commercial, etc.) match or vary from those of the Acquiror

2. Manufacturing facilities: type, newness, capacity, compliance (environmental and regulatory)

3. Breadth and experience of the management teams

4. How many new products are in the pipeline; market shares are important but often hard to measure often

5. Any anti-trust issues that will be raised by your joyful ascent to market dominance or by your acquiring too many of the marbles (viz. the Sandoz purchase of Ciba Geigy and its presumed impact on gene therapy expertise in the eye of the FTC).

6. Compatibility of corporate cultures (including pay scales) in order to retain key people

E. WEIGH UP FINANCIAL AND TRANSACTIONAL ELEMENTS

1. Does a deal for the Target even look feasible, given the ownership structure or financial needs of its shareholders? Key factors are the existence of a large shareholding whose transfer facilitates a deal; financial problems of a living person or a recently created estate; realisation needs and time-frames of Venture Capitalists; investment/cash requirements of loosely-affiliated industrial shareholders, etc.

2. How will any deal be paid for, cash or shares? (for example, the latter being less acceptable in Southern Europe than in the UK or Northern Europe)?

3. What minimally acceptable level of ownership is sought…for control and/or for accounting purposes.

4. How much can the Acquiror <u>maximally</u> spend to win the deal?

5. If a friendly deal cannot be done, can a hostile deal be completed? If so, at what risk to "perishable" assets like management or R&D staff in a competitive environment

6. Prospect of being overbid by competitor, once a given deal is “in the air” but not yet finalised.

7. Pay attention to local rules, such as the UK Stock Exchange “Blue Book” rules, containing requirements such an Acquiror buying 30% of a public company must bid for the remainder

8. What about foreign currency considerations? This factor has a high impact on reportable earnings if the Target (and other non-US operations of the Acquiror) are in volatile currency locales.

9. Watch out for regulatory filings with securities or merger authorities (anti-trust rulings) and, in some countries, Foreign Investment Review agencies covering the acquisition of a local company by a foreign entity. These elements frequently engender a delay in closing a deal (sometimes, closing follows exchange of contracts by some weeks as a result of these factors)……and might leave completion susceptible to an inimical intervention by a third party….so tie up the loose ends early.

V. BASIC STEPS TO IMPLEMENT YOUR ACQUISITION PROGRAM

A. CLARIFICATION OF RESPONSIBILITY AND FRAMEWORK FOR THE TRANSACTION

1. Selection of the Acquiror’s inside management team, including deciding who leads the due diligence, who runs the actual negotiations and with what authority.

2. Allocation of tasks to outside advisors, especially lawyers (for the legal context of a deal and IP rights); accountants (to analyse the financial data presented in foreign languages and unusual formats); consultants (for environmental and product liability matters); and, most important! investment bankers (to aid with strategic advice in valuation, structure and negotiation).

3. Establishment of time deadlines for various phases of the deal.

4. Provision of guidelines on secrecy

B. SOURCES OF INFORMATION

1. Annual Reports, with science/technology/product introduction and press release packages, for both public companies and some larger, older private companies

2. Corporate briefing materials, especially for private Targets, including technology description and product literature

3. Industry publications, (like Animal Pharm, industry marketing reports etc.).

4. News archives from magazines, journals and institute proceedings

5. The Internet, linking (a) to hubs on topics like catalysts or diabetes or (b) to company-specific sites or (c) to databases on the industry to which the Target belongs.

6. Research reports from brokers or industry analysts

7. Interviews with industry experts, sometimes retirees from the Target company or from comparable businesses.

8. Biographies of, and news interviews with, the company founders or leading executives, usually vanity pieces for which unusually clear and proud disclosure is made.

9. Information "books" from already-decided sellers of the Target (usually prepared by investment bankers or accountants).

C. APPLICATION OF SELECTION CRITERIA (from Section IV) TO THE ACCUMULATED INFORMATION ON A TARGET (from Section V.B)…….most helpful to do in this sequence (slide)

1. Size - Note that a simplistic utilisation of (a) an industry-specific multiplier of the (usually historic) Target's Revenue (the most easily known piece of data) and (b) an industry-specific multiplier of either pre-tax profits or invested capital will each give a fair approximation of Deal Value.….and rule a given Target in or out of the first shortlist of candidates.

2. Location (or not, as the case may be)

3. Fit on the Product level… and, for young or developing Target companies, on the Technology level

At this point, the Acquiror should have a list of more-or-less properly sized Targets located in the chosen country or countries and possessing the key desired business characteristic…..…so further winnowing is still required to end up with a shortlist of "best" Targets.

4. Operating Aspects of the Business - this category is, by far, the hardest to accumulate data upon and to judge from a distance……but is crucial in eliminating obviously unworthy Targets from further consideration ….. particular importance to screening out a deal is paid by Savvy Acquirors to the anti-trust, management and marketing factors.

5. Financial and Transactional Elements - especially those concerning the ownership level sought, nature of the shareholder body, likely value expectations of current owners, valuation of the Target by the Acquiror/advisors, and other decisive factors like:

   (a) In Bilateral Transactions (at the Acquiror's initiation or by its acting pre-emptively within an auction)

   discern the history and psychology of the owners and managers in order to make an unthreatening, comfortable approach to them concerning an overt or hidden "willingness" to sell….preferably to the Acquiror specifically.

   such an approach is best made by an outside party, typically an investment banker skilled in M&A and intercultural behaviour differences

   an argument in favour of a deal must be simple and persuasive, frequently going beyond money matters:

   family succession

   financial rescue

   maximising shareholder value, in cash or in Acquiror shares

   complementary strengths (like Acquiror's R&D being matched with Target's Manufacturing and Marketing or Acquiror's product line A being sold to the same customers as the Target's product line B).

   selling a non-core subsidiary can be the financial equivalent, for the seller, of having an offering of new equity

in the case of a public company with many prominent directors or even a highly secretive family company, it may be useful to sound out current views on a change of ownership by talking to a "neutral" director, banker, or lawyer close to the scene

job security for key people, continuity of R&D projects/products, maintenance of Target's name

(b) In Auction Transactions (both wide or invitational in style)

Speed and decisive action (in meeting the seller's tight timetable deadlines) will count for a lot in conducting your due diligence investigation and negotiations: don't let a rival boat get ahead of you to the best beaches… and don't waste time on minor, or non-value impacting elements… go for the key macro, high value factors in due diligence and negotiation… this approach will always impress the sellers and their advisors, gaining such an Acquiror a reputation for being excellent and user-friendly.

D. CROSS-CULTURAL AWARENESS

An Acquiror must always take into account differences of culture and traditions of negotiation processes abroad, such as:

1. access to information - is much more limited and less often validated

2. the legal system - especially regulations on acquisition (by foreigners), tax and employment are more onerous to comply with, substantively and procedurally

3. the contract documents - similar in the UK and other Anglo countries to those found in the USA, but are very diverse and frequently peculiar in structure and content elsewhere

4. behaviour of owners and of deal negotiators - be aware that different cultural imperatives motivate them and condition their responses to deal points, especially in "proud" countries like Japan, France, China and the CIS.

E. GETTING TO CLOSING:

Many things can have an impact at the last, smooth minute of your moving to a successful completion of a deal that looks otherwise good on paper, such as:

Price demanded by Target is out of reach

(structurally) for Acquiror <u>or escalated abruptly</u> or_deal format changes

<u>Employment</u> required by the Target <u>for</u> its "<u>surplus</u>" <u>executives</u> or clinging family members

<u>Refusal by</u> a Target's <u>alliance partner</u> (or patent holder) <u>to consent to a novation</u> in prior arrangements

Overly finicky <u>lawyers or accountants, stretching too far</u> in final negotiations for the Acquiror

<u>Government intervention</u>, from anti-trust, tax, securities or merger notification authorities

<u>Abandonment</u> of the Target, or a failure to attain Board approval, by the Acquiror's internal supporters of such a deal (in soccer parlance, an "own goal")

For all these rocky patches, and more, there are creative solutions envisagable……..so turn loose your internal teams and your outside advisors like Ferghana - and, if you don't consummate the acquisition, for any reason, you can console yourself with the maxim that "good deals do get done" and move on to the next Target.