M&A market reignites

M&A VOLUMES IN THE CONSUMER AND HEALTHCARE SECTOR ARE INCREASING AS FIRMS SEEK GROWTH, ESPECIALLY IN NON-OECD MARKETS. COMPANIES EMBARKING ON EXPANSIONARY STRATEGIES NEED TO ENSURE THEY HAVE A BANKING RELATIONSHIP IN PLACE THAT WILL SMOOTH THE PROGRESS OF THEIR TRANSACTIONS, ACCORDING TO **STEVE ELMS** AND **MARK JONES**.

During the financial crisis, stock markets placed a premium on the importance of consumer and healthcare companies retaining liquidity. As a result, many firms ended the crisis with significant cash war chests. As the financial environment has changed, shareholders have increasingly demanded that this cash be put to use.

As a result there has been a sharp rise in buybacks and acquisition activity: $300bn of global mergers and acquisitions (M&A) were announced in January – the fastest start to a year since 2000, according to Thomson Reuters.

At the same time, demand in OECD countries remains constrained as a result of the relatively sluggish economic recovery. However, the broader global economy is growing strongly – especially those emerging market countries that Citi describes as Global Growth Generators or 3Gs. These 3G countries, including China and India, have the greatest growth potential based on domestic saving and investment, demographic outlook, health, education, quality of institutions and policies, and openness to trade.

Corporates are therefore taking much more of a global view when it comes to their strategic acquisition strategies, as has been demonstrated by much of the M&A activity in 2011 so far from 3G countries.

THE CONSUMER MARKET – PAYING A PREMIUM? Publicly traded corporate stock prices were hard hit by the economic crisis in 2008. Although prices have recovered, the valuation of many recent M&A deals has been much greater than the current market value as indicated by share prices. This is a sign of renewed confidence. It also shows that corporates have departed from their wait-and-see approach: instead, they are eager to put stockpiled cash to use.

As a result of growth in 3G countries, commodity and other costs in the consumer sector continue to rise. Given that demand remains broadly flat in many markets, companies are not able to pass on their increased costs and therefore margins continue to be under pressure. Corporates are therefore aiming to use internally generated cash more efficiently and – most importantly – are seeking expansion opportunities in 3G countries.

Many consumer companies have felt the impact caused by the economic crisis, which has resulted in a decline in net sales, but those more severely affected are companies with the greatest reliance on OECD markets. As a result, many have chosen to refocus their business away from mature markets.

Companies with an existing footprint may be able to expand their activity in 3G markets but for many firms the fastest way to tap growth in these markets is often through M&A. Many 3G countries not only have rapidly growing economies, which traditionally lend themselves to lower-end brands, but also have an emerging middle class with an increasing demand for premium, higher-margin, OECD-style products. Consumer brand companies are therefore seeking breadth and depth in their branch portfolios in these rapidly growing 3G markets.

One company that highlights many of the trends occurring in the consumer market is Diageo. In February, Diageo announced plans to acquire Turkey's largest spirit maker, Mey Içki, for £1.3bn and it is currently awaiting regulatory approval to buy a controlling stake in China's Sichuan Chengdu Quanxing Group. The moves are part of a continuing trend of companies adding to their brand portfolio across the sector through strategic acquisitions while also positioning existing brands in 3G countries.

At the same time as consumer companies are expanding into 3G markets they are looking for growth opportunities within established OECD markets. While consumer demand overall may be flat, some market segments are experiencing strong growth. For example, among developed market consumers there has been a marked focus on quality as they seek perceived longevity and a "feelgood" factor in their purchases: consumers may be more cautious with their spending but they are ensuring that the money that they do spend improves their lifestyles. Consumer companies are positioning themselves accordingly.

Other changing consumer habits include the trend towards healthier lifestyles, which has led to a change in demand. For example, there has been a transition to non-carbonated

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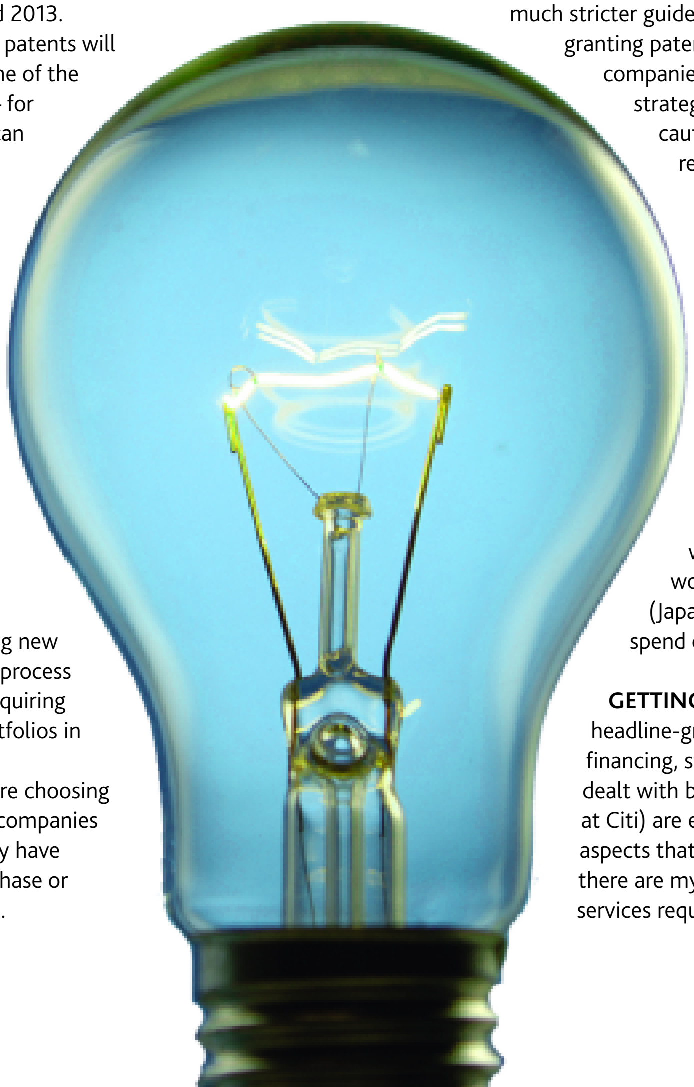
soft drinks and a growing prevalence of energy drinks. Similarly, some years after it became a major component of the US beer market, low-calorie beer is finally making a significant impact in European markets. Companies are eager to tap these new areas of consumer spending and where they do not have brands that can be easily leveraged into new markets they are making acquisitions to expand their portfolios, such as the purchase of protein, vitamins and minerals milkshake brand Nutrament by Nestlé in December 2007.

HEALTHCARE – SOFTENING THE BLOW The healthcare sector, like the consumer sector, is affected by rising commodity costs that are hard to pass on to consumers – individuals, private healthcare providers or public sector providers, which may be operating under budgetary constraints given the economic environment. An added pressure in the healthcare sector is the threat from generic drug manufacturers: pharmaceutical companies are unable to raise prices for fear of losing business to generic companies.

Generic drug providers are also the source of a major threat to pharmaceutical companies because of an impending event known in the industry as the "patent cliff". A number of successful or blockbuster drugs are now coming out of patent protection – the patents were granted 15 to 20 years ago. In 2010, the pharmaceutical industry had sales of $860bn. Just 133 blockbuster drugs accounted for $295bn of those sales – about 34% of the market – according to market research group IBISWorld. Of those 133 blockbuster drugs, 61 drugs worth $80bn will go off-patent at the US Patent and Trademark Office between 2011 and 2013.

The impact of the expiry of those patents will be huge. Single drugs owned by some of the largest pharmaceutical companies – for which patents will expire shortly – can generate billions of dollars of sales. Once a patent is lost, the generic manufacturers quickly look to replicate such drugs and capture a large percentage of sales with pricing that averages just 30% of the original drug's sale price. As a result, about 90% of revenue from sales of blockbuster drugs disappears in the first two years after a patent expires.

The huge potential shock to revenue growth for the $860bn global pharmaceutical industry is driving it to pursue a number of initiatives. Companies are developing new products – a lengthy and expensive process – leveraging existing products, or acquiring other companies and their drug portfolios in order to grow revenues and profits. Increasingly, pharmaceutical firms are choosing to partner with smaller life science companies or to acquire them, either when they have achieved their first successful trial phase or once products have been developed.



Pharmaceutical companies are also seeking to increase new business streams such as consumer health and are diversifying and pushing into new areas such as biotech. Biotech drug discoveries are much harder to replicate given the complexities and high costs associated with DNA research and therefore have a longer period of strong sales revenue.

Recent acquisitions by pharmaceutical companies eager to enter biotech include Roche's $46.8bn acquisition of US firm Genentech in March 2009 and Sanofi-Aventis's $20.1bn acquisition of Genzyme, which was announced in February this year. More generally, many pharmaceutical companies are engaged in ongoing product portfolio alignment, which results in continued acquisition and divestiture activity as market participants focus on streamlining their product and business portfolios.

At the same time as they look for opportunities to diversify both organically and through acquisition, pharmaceutical companies are aiming to tap new markets. Although already one of the world's most sophisticated healthcare markets, Japan offers potentially large rewards. It is the largest consumer of healthcare products globally and its culture and traditions ensure a steady growth in consumer demand for health-related consumables.

Healthcare companies are also following the trade flows that are coming to dominate the broader global economy by expanding into 3G countries. Given differing approaches to patents in some emerging markets – India, for example, only recently recognised the intellectual property process in the drugs industry and still has much stricter guidelines and policies when it comes to granting patents – large pharmaceutical companies need to be cautious in their M&A strategies. However, provided that caution is applied, the potential rewards are significant.

The most important – and the largest – of all 3G countries is China, and its growth in healthcare spending is expected to keep pace with its rapidly growing economy.

Spending on healthcare in China is predicted to rise from $30bn currently to $100bn in 2015 as a result of the government's commitment to improve public health. By then it will have overtaken Japan as the world's largest healthcare market (Japan is expected to have an annual spend of up to $90bn by 2015).

GETTING THE RIGHT SUPPORT The headline-grabbing aspects of M&A such as financing, strategy and advisory (which are dealt with by a dedicated market-leading team at Citi) are essential and, of course, are the aspects that result in transactions. However, there are myriad additional products and services required to support and service the

AS COMPANIES IN THE CONSUMER AND HEALTHCARE SECTORS BECOME MORE ACQUISITIVE IN PURSUIT OF THEIR GEOGRAPHICAL AND PRODUCT PORTFOLIO GOALS, THEY ALSO NEED TO CONSIDER THE MERITS OF BUILDING A RELATIONSHIP THAT EXTENDS BEYOND A SINGLE M&A TRANSACTION.

M&A transaction from both the buyer and seller's side in order to ensure a successful deal.

For example, in order to facilitate a full acquisition, the acquirer will normally require a paying, tender or exchange agent to manage a variety of transaction-related services ranging across the entire acquisition process. This will include preparing and updating a shareholder register to take account of those shareholders in the target company looking to exchange their equity or debt for cash, the distribution to shareholders of offer documents, collection and monitoring of securities, processing submissions, coordination and distribution of cash, debt or equity consideration, the provision of reports and any tax reporting requirements.

M&A transactions may also require an escrow agent. While often overlooked until the last moment, escrow agent services play an important role in controlling and minimising counterparty risk in the closing of a transaction or in addressing considerations such as tax, management retention and pricing. Typically, the escrow agent receives, safe-keeps, services and disburses assets in accordance with specific terms and conditions established through an underlying escrow agreement.

Another role similar to that of an escrow agent is closing agent. This role enables the funds flow on a complex cross-border transaction involving multiple jurisdictions and currencies to proceed smoothly and without incident in a timely and risk-controlled manner. A bank with a global reach can provide a single point of contact for a client to facilitate payments of this nature, avoiding the need to involve multiple correspondent banks in different geographies trying to coordinate the closing of a transaction. Outsourcing the transactional banking requirements in this way effectively frees up both the buyer and seller to concentrate exclusively on the commercial aspects of the transaction.

Within many companies, the decision-makers in the M&A process – which vary between companies but often include the treasurer, M&A team and external legal counsel – are often focused on the headline aspects of the transaction. The numerous additional products and services required to ensure the deal goes smoothly are frequently not considered in advance. Moreover, given the occasional or one-off nature of M&A for many companies, many decision-makers may not even be aware of some of the services they will require (among companies that make frequent acquisitions there are exceptions but these are limited in number).

Necessarily, discussions within companies about issues as central to their future as M&A tend to be at a high level between board members and legal counsel. Frequently, lawyers will be relied on to make recommendations as to which banks are best suited to provide such services. Inevitably, lawyers tend to recommend banks that they have worked with before and Citi has invested great effort in building relationships with leading legal practices to ensure that corporate clients gain the benefit of its expertise in M&A transactions.

More generally, corporates in the consumer and healthcare sectors need to consider for themselves how they can most effectively engage banks when considering an individual acquisition or a broader acquisition strategy.

Corporates need to define internally what criteria to use when they evaluate potential banking partners. Cost is clearly important in selecting a bank partner for M&A-related services, as is a good track record. As companies in the consumer and healthcare sectors become more acquisitive in pursuit of their geographical and product portfolio goals, they also need to consider the merits of building a relationship that extends beyond a single M&A transaction.

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