KPMG

The Life Sciences asset swap opportunity

Difficult to achieve but worth the effort?

Realizing value series

Innovative initiatives to refocus portfolios and build category leadership continue to be high on the C-suite agenda. With deal volumes expected to rebound throughout 2018 and beyond, could asset swaps make a resurgence? While executing these deals is not without significant challenge, the benefits achievable can be sizeable.

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An innovative model to address sector challenges?

Asset swaps may provide an attractive solution to some of the industry's most pressing challenges.

The difficulties currently facing Life Sciences companies are significant and wide-ranging. From exorbitant and rising R&D costs to continuous downward pricing pressure, and increasing regulatory burden to the mounting impact of recent geo-political events (including significant US tax reform), the Life Sciences industry is undeniably confronting a difficult innovation and commercial environment.

A number of strategies to respond to this demanding situation have evolved in recent years, including more aggressive acquisitions and divestments of assets in a bid to rationalize portfolios and focus on fewer segments in which companies can dominate. More recently, there was a surge of M&A at the start of 2018 which is predicted to continue going forward. Asset swaps could present an attractive transaction model, providing that the right deal can be struck.

KPMG professionals have had recent conversations with heads of business development functions which suggest that the appeal of an asset swap remains high given that they have important advantages over traditional M&A. Despite this however, they are not without considerable challenges. In this paper, we reflect on KPMG member firms' experience of having advised on some of the largest asset swaps to date and examine how best to execute these deals successfully.

The strategic and financial benefits of an asset swap

To stay ahead of the game, an asset swap model can be used to accelerate strategic ambitions.

Whilst there have been relatively few asset swaps in the Life Sciences industry to date, those that have been delivered have been sizeable and transformative for the businesses involved.

Asset swaps can be a powerful tool in the corporate armory and offer several advantages alongside and above traditional M&A. In addition, recent US tax changes are likely to increase appetite for innovative deal making.

Case study 1: GSK/Novartis

In 2014 GlaxoSmithKline (GSK) swapped its oncology business to gain Novartis' vaccines unit, and simultaneously entered into a joint venture (JV) of over-the-counter (OTC) products to create one of the world's biggest consumer health businesses[1] (more recently, GSK have bought Novartis' share of the JV).[2] GSK became a leader in the vaccines market, including in anti-rabies and meningitis[3], whilst Novartis strengthened its dominant position in oncology, gaining new drugs such as Votrient, which targets kidney and soft tissue cancer.[4] Novartis also secured commercialization rights of future oncology products and rights to GSK's AKT inhibitor. In this example, GSK paid US$5.25 billion for the global vaccines business in conjunction with milestone payments of up to US $1.8 billion with ongoing royalties, whilst Novartis paid US$16 billion.[5] Novartis paid a substantial amount more with the view to boost its short-term profitability as the profit margin for the oncology portfolio was up by 33% in 2014 compared to the prior year.[6]

Case study 2: Boehringer Ingelheim/Sanofi

In June 2016 Boehringer Ingelheim agreed to exchange its consumer medicines division valued at €6.7 billion for Sanofi's animal health business valued at €11.4 billion in a deal valued at US$12.6 billion, with a cash payment to Sanofi of €4.7 billion to reflect the difference in value of the two businesses.[7] The Chairman of the Board stated that Boehringer viewed the swap as an opportunity to 'prospectively become one of the largest global players in the animal health segment'.[8] Meanwhile, the CEO of Sanofi stated that the innovative deal had allowed them to meet 'one of the key strategic goals of their roadmap 2020, namely to become a leader in consumer healthcare'.[9]

There are five key advantages of an asset swap over traditional M&A.

Advantage 1: Targeted focus

First, the asset swap model can be more targeted than M&A, aimed at boosting growth in core businesses and off-loading unwanted assets to improve return on investment. Perhaps most importantly, from a strategic perspective, asset swaps can provide an unprecedented level of precision in a deal. In a traditional transaction, the acquisition of a corporate entity may include products or business units that the buyer does not wish to retain. However, in an asset swap, what is included or excluded from the swap can be selective, meaning that only those assets which are of commercial value to the broader portfolio are acquired.

Category leadership offers a mutually beneficial exchange between two parties where each sees a chance to gain access to a therapy or business area that promotes their strategic objectives. The deal may also offer participants the opportunity to reach new geographies, distribution channels and specialist capabilities they have previously lacked.

As this is a relatively new model and way of thinking for the sector, many are firming up on their strategic positioning to specialize their portfolio in one area. This is in an attempt to enhance their leading position in the market by achieving a consolidated portfolio.

– Vir Lakshman,
Partner and Head of Chemicals and Pharmaceuticals,
KPMG in Germany

Advantage 2: Portfolio speed-building

Asset swaps offer an effective approach for companies to build critical mass bilaterally and quickly in a specific area in line with their business strategies and product portfolios. Whilst the complexity of asset swaps means they often take time to action, once agreed, the fact that both companies can simultaneously acquire and divest respectively enables both to speed up portfolio reformulation.

Advantage 3: Financial efficiency

Asset swaps can be significantly more financially efficient than other forms of M&A. Timed well, this can be the most appealing characteristic of an asset swap and an important advantage. For example, following the traditional sale of an asset, shareholders rightfully expect management teams to put funds to work immediately as cash held in the bank can adversely impact shareholder value. This is not a concern in an asset swap where the form of the transaction is typically accretive to companies' earnings per share by accelerating revenue and earnings growth rates. Furthermore, it is typically viewed positively for long-term growth and value creation.

This type of deal immediately enhances the respective portfolio of the parties. If cash alone was received in disposing an asset, which is usually the case in traditional M&A, the company would be expected to deliver quickly on its portfolio investment strategy, which realistically, may take some time.

– Tobias Valk,
Partner and Head of Deal Advisory, KPMG in Switzerland

Parties are also likely to gain a better balance between return on investment and the cost of capital in an asset swap scenario. For example, there is a reduced need to seek funding from capital markets and no requirement is needed to use one's own funds in contrast to a traditional M&A deal.

Advantage 4: Mitigated risk

A further benefit of an asset swap over and above selling or buying an entire company is that there is no requirement to acquire existing superfluous resources from the selling company. Several risks can be mitigated by employing this selective model. For instance, overall company acquisition risk and historic liabilities may be reduced, particularly in terms of tax treatment.

> **Historic tax issues may appear that were not spotted during due diligence. The swap allows the parties to cherry pick the components of the transaction. The target business can be relatively clean, reducing the risk of problems coming out after the deal, leading to accounting write-downs or actual cash liabilities arising.**
>
> – Melissa Geiger,
> Partner and Head of International Tax, KPMG in the UK

Advantage 5: Deal differentiators

There are five key deal differentiators that can help companies realize value over and above traditional M&A:

1. Asset swaps can help alleviate the cost-cutting risks associated with mergers. If the company is already a corporate with scale, it warrants more of an incentive for the company to swap assets instead of producing a mega-merger with higher costs.
2. An asset swap can be introduced as part of a larger competitive deal to drive down the overall price of the transaction and ultimately close the deal as quickly as possible. Vir Lakshman adds: "Asset swaps can be used as a 'sweetener' when exploring ways to align and deliver the CEO's overall strategic goals for the business".
3. Swaps allow transparent assessment of assets in both companies in order to avoid unfocused or ill-fitting assets being acquired that do not align with the company product portfolio, which could be the case in an M&A.
4. As many companies lean towards becoming global leaders in fewer areas, asset swaps pave a clear way for this to occur.
5. Asset swaps have an interesting vantage point where they have been used to overcome regulatory barriers. For example, they have been used to assuage policy makers' concerns about competition in the sector, which can be a concern in traditional M&A.

Key success factors for asset swap success

Adopting winning measures to help deliver asset swap success.

Strategic clarity, scope and IP alignment

For an asset swap to be successful, it is imperative that both parties' objectives align on the scope of the transaction. For Tobias Valk, this is pivotal for clients: "Agreeing and achieving the right scope is critical in this type of deal. This is especially true as it leads to increased involvement from senior management compared to regular M&A transactions due to the greater complexity of the deal. As a result, a clear understanding of the assets is required to ensure transparency is achieved".

Both parties have a vested interest in ensuring the terms and parameters of the transaction are agreed. To enable this, full disclosure of information regarding the assets is required from both parties.

> **The strategic alignment of two companies is very much the same as dealing with one party; strategically it makes sense to remove any uncertainties early on in the transaction and permit transparent information flow.**
>
> – Vir Lakshman,
> Partner and Head of Chemicals and Pharmaceuticals,
> KPMG in Germany

In addition, both businesses would have much more interest in the deal compared to traditional M&A due to a need to understand what assets are being received or sold and at what value. Valk adds: "A key component is to ensure a dedicated core team is in place to handle the transaction and keep control of the assets received, together with the need and responsibility to integrate these effectively in the company".

Intellectual Property (IP) is also a major consideration. In these types of deals, significant value will be embedded in the IP. It is important to understand what IP is being exchanged as part of the transaction, the geographical location of it and how it is being used.

> **Value that flows from IP can form a significant part of any future business plan and some thought will need to be given to understand how the acquired IP will be leveraged to align and fit with existing IP portfolios and the broader business strategy.**
>
> – Melissa Geiger,
> Partner and Head of International Tax, KPMG in the UK

In addition, moving IP after the swap can involve significant operational costs and upheaval. Therefore, there are clear advantages in considering future plans for IP as part of the transaction to ensure that it is acquired into the correct business unit or geographical location at the time of the deal. This involves assessment of value, infrastructure support, people functions and any innovation incentives or grants the business could opt into in order to maximize return on IP, as well as keeping in mind exit strategies and how to ease future divestment when necessary. This will ultimately allow IP and other valuable assets to be fully aligned with the wider commercial strategies from the very start and allow the business to function quickly with the new assets.

Trust and reciprocity

A greater deal of trust is often necessary in a swap which tends to imply a closer partnership between parties; both companies need to work harmoniously and put aside traditional competitor rivalries during this transaction.

Tobias Valk comments: "In practice, trust between the two parties is needed to ensure the value of the assets are correctly portrayed for each party. Trust is also greatly linked to the practicality of the deal: if critical information is held back during the deal, this will hinder any progression for both, so it is of mutual interest to ensure a more free flow of information is established compared to M&A". If executed correctly, the swap creates a degree of comfort, and a sense of security and understanding, adding weight to the degree of trust necessary to secure the deal. This is especially true when relying on support from the other company in providing supplier agreements, for example, to enable the deal to be processed swiftly.

Finding the right partner with mutual interest is also a critical success factor for both parties' strategic objectives. This heavily weighs on finding the right partner at the correct time for the swap. Vir Lakshman comments: "The deal needs to be done at the right time that is feasible for both companies, otherwise both companies fall into a lack of reciprocity and thus misalignment".

Effective valuations

In a swap, parties receive a consideration of assets rather than just cash. The valuation of assets being transferred in both directions is important to understand for taxable loss and gains. This is due to the tax liability that arises as a result of the valuation and is a key factor when considering a swap. Fred Gander, Partner-in-Charge, US Tax Services, KPMG in the US, comments: "The taxable gain or loss during valuation for both companies on an asset-by-asset basis could impact the business structure, and whether the assets can or should be moved to a different geographical location". An effective valuation requires unimpeded and open information flow from both sides supported by robust due diligence. This is critical in promoting accurate and mutually agreed valuations of both business units.

Interestingly, if there is a 'like for like' swap and a measure to assess the valuation similarities of the asset based on market value (e.g. on what the product brings in terms of revenue generated for the company), this would defer taxable income from the swap, which could be material and significantly advantageous for both companies.

Robust post-deal value capture plans

Future strategy

Before successful execution of the swap, the post-deal impact on the business should be assessed. The parties need to be aware of the impact on business operations to ensure the necessary resource pools are ready. This is to mitigate any pressure on business functions whilst on-boarding and integrating a new asset. Vir Lakshman asserts: "An example of business operations remaining fluid is to ensure the infrastructure is appropriately carved out in the IT division and that they understand the necessary adjustments required to accommodate the asset".

Forecasting what the future strategic implications could be post-deal is pivotal to ensure value borne from the swap is driven out once the asset is embedded. Once the deal is executed, the companies' objectives are refined and geared to deliver value from the newly acquired asset:

> **This could mean that capital, resource and funding will be aligned to realize value for both the company and shareholders.**
>
> – Vir Lakshman,
> Partner and Head of Chemicals and Pharmaceuticals,
> KPMG in Germany

Much of this is due to the scale of the type of deal being much larger than an M&A and so a shift in strategic priorities would be necessary.

Transitional Service Agreements

Transitional Services Agreements (TSAs) are important to ensure continuity in all deal types. They are especially crucial in asset swaps, where a business unit may need to migrate away from all its corporate support functions, and continue to function effectively and efficiently. Having a robust TSA in place can ensure that the swapped entities continue to operate after the deal. This is with minimum disruption to operational and staff productivity, thereby preventing cost increases and reputational damage.

Integration

The simultaneous nature of the swap creates complexity as both parties coordinate integration with separation. Capturing maximum value from the deal for both sides requires business continuity and goodwill. In addition to the support they gain through the TSA, each party should plan the management of internal resources for the transition, define and quantify the value proposition for buy-side and sell-side (across commercial, R&D and supply chain), and prepare a value capture plan for the integrated business.

Business as usual

It is important to ensure that divested businesses continue to be properly managed during the post-deal period. This entails paying people and vendors, establishing security, IT and relocation plans, maintaining supply chain and manufacturing, and supporting pharmacovigilance and other regulatory necessities.

A viable alternative to traditional M&A

Action points for CEOs:

As deal activity heightens and attention shifts towards more innovative transaction types, companies could use the asset swap as an effective vehicle to execute their strategy. First, companies should determine their core competencies and position in the value chain. Second, they should carefully consider and be prepared to divest assets that do not fit with their long-term strategic ambitions. And finally, they should identify other assets which could help them dominate their core segment.

Once they are business ready and the right market opportunities prevail, companies should consider and prioritize the asset swap, given the benefits outlined below over traditional M&A:

- Rapid, financial impact enabled by the transaction for both the business model and shareholder value
- Reduced risk of historical tax liabilities carried by the asset swap
- Enabled selection of assets that support overall business strategy without additional M&A cost burden

The key success factors that can support a successful asset swap include:

1

Transparency and trust between parties to enable strategic and operational alignment

2

Clear line of sight of IP value flow and integration with existing assets

3

Unimpeded information flow that ensures asset valuation is mutually agreed

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Actions:

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