Bristol-Myers Squib Buys Celgene

AUTHOR

Thibaud KAST
Thibaud.kast@edhec.com

A few hours after analysts announced that the current period was not very likely to see any mega-deals in the pharmaceuticals industry, Bristol-Myers Squib (BMS) announced the acquisition of Celgene, which would have become one of the biggest deals in history for the industry.

Before we start, it is important to understand the activity in terms of mergers and acquisitions in this industry. The first part of this article will be briefing the pharmaceutical industry. The second part of this article will be an overview of the acquisition. Finally, based on the second part, we will finish with a deep focus on the true drivers of such deals.

The Pharmaceutical Industry Overview

After (TMT) Technology, media and telecommunication and the oil & gas industry, the pharmaceutical one is the most active in terms of mega deals since the 90's. In fact, Pfizer has always been a main actor since the 90s in terms of M&A activity.

- Market size & growth

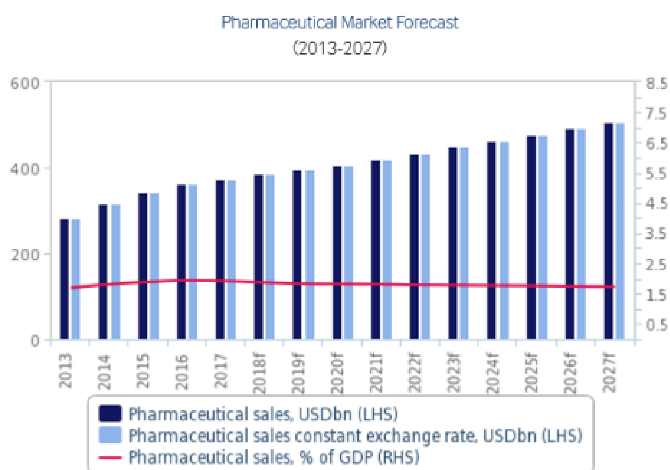
Figure 1: Pharmaceutical forecasts in the United States

HEADLINE PHARMACEUTICALS & HEALTHCARE FORECASTS (UNITED STATES 2016-2022)

Indicator	2016	2017	2018f	2019f	2020f	2021f	2022f
Pharmaceutical sales, USDbn	362.129	373.323	385.400	395.208	408.029	421.224	434.759
Pharmaceutical sales, % of GDP	1.94	1.92	1.87	1.83	1.82	1.81	1.79
Pharmaceutical sales, % of health expenditure	11.3	11.1	10.9	10.7	10.5	10.4	10.2
Health spending, USDbn	3,198.105	3,369.195	3,523.518	3,691.669	3,872.317	4,057.641	4,249.450

f = Fitch Solutions forecast. Source: National sources, Fitch Solutions

Figure 2: Pharmaceutical market forecasts



The pharmaceutical industry comprises companies involved in the development and manufacturing of prescription drugs and over-the-counter products that are used to prevent or cure diseases in humans or animals. The primary focus of the pharmaceutical industry are companies that develop brand name drugs that have patent protection. In 2017 the industry recorded revenues of $1,143.3 billion with $228.6 billion in profits. The industry as a whole is worth $934.8 billion The annual growth in the industry has been around 3.6% between since 2012. The industry employs 500,000 people and contributes to 3% of GDP.

The expiration of patent allows generic pharmaceutical producers to compete with these brands. This high level of competition leads companies to outsource innovation of new biological drugs to reduce R&D risks. Technological development and breakthroughs are essential in this industry, however, the cost of developing new drugs is estimated at $1.2 billion, limiting the ability of investing in new drugs development for various new entrants. In addition, only 20% of the drugs reach a breakeven point.

So far by analysis, the main challenges of the industry are: <u>expiring patents leading to higher competition</u>, <u>slower sales growth</u>, <u>a decreasing trend in innovative drugs</u>, and <u>stricter regulations and standards</u>. Despite all these, the industry is expected to benefit from aging population worldwide.

- <u>SWOT analysis</u>

Strengths: US pharmaceutical market is the world's largest one with $373bn in size which is three times bigger than Japan with $95bn, the second biggest market. Branded products account for a large part of the market. Despite strict regulations, the limited pricing restrictions allow high margin strategies. The industry is a leader in terms of R&D expenses.

Weaknesses: In the US a big part of the population are not insured and cannot afford expensive treatments, the market is in the mature phase. There exists a high and intense competition, with high barriers to enter for new entrants with extremely high costs of development of new products.

Opportunities: Generic drug makers benefit from patent expiration, therefore reaching poor population. Aging population is a great opportunity, meanwhile the opportunities to expand in China and India, which are still relatively small market (respectively $155 billion and $27 billion) exist.

Threats: Public and political opinion on drugs' pricing. The high number of patents expected to expire. The US FDA is becoming stricter on regulations.

With the new Affordable Care Act of President Trump, the US pharmaceutical industry is undergoing considerable changes.

An example of how big the market is: the state of California consumes a similar value of medicines (USD44.97bn) as compared with the whole of France (USD44.80bn).

- <u>Competitive landscape:</u>

The four largest companies have over 40% of the total industry revenue. There are multiple reasons why only four major companies own almost half of the total industry's revenues. Mergers can explain this trend, such as Pfizer-Wyeth, Merck-Schering-Plough, and Roche-Genentech.The big players in this industry are J&J (10.4% of Market share), Merck (9.6%), Pfizer (8.8%), Bayer and GlaxoSmithKline (both with roughly $20bn of revenue).

- Corporate finance activities:

Merck, Pfizer, and J&J are candidates that are likely to expand via M&A. The external growth is an integral part of pharma companies. They all have a lot of cash and can make acquisitions to boost their mid-late stage pipelines. Companies remaining as likely targets are the ones with therapies that have recently gained approval or otherwise likely to gain soon in potential areas such as oncology, rare diseases, and gene-editing technologies.

There are lessons for other industries in the way pharma companies use mergers to innovate, work more efficiently, and bolster product portfolios. The transition of US tax reform in late 2017 led to speculation that M&A activity would soon skyrocket among pharmaceutical companies, due to tax-cut benefits to sellers. That has proven to be the case: in the first half of 2018, there were 212 deals (worth more than $200 billion), up from 151 such deals in the year-earlier period.

Below are the biggest deals realised in the industry in the last two decades and illustrates the mega deal trend inherent in the pharmaceutical industry.

Figure 3: Top 11 of the biggest acquisitions in the pharma industry

Year	Acquirer	Target	Transaction Type	Value with debt (in billions of USD)	Value with debt (Adjusted for inflation)
1999	Pfizer	Warner-Lambert	Acquisition	111.8	168
2000	Glaxo Wellcome Plc	SmithKline Beecham	Merger	76.0	111
2019	Bristol-Myers Squibb	Celgene	Acquisition	95.0	95
2004	Sanofi	Aventis	Acquisition	73.5	86
2015	Actavis	Allergan, Inc	Acquisition	70.5	75
2009	Pfizer	Wyeth	Acquisition	68.0	79
2002	Pfizer	Pharmacia	Acquisition	64.3	90
2018	Takeda Pharmaceutical	Shire	Acquisition	62.0	62
2016	Bayer	Monsanto	Acquisition	54.5-63.5	57-66
2009	Merck & Co.	Schering-Plough	Acquisition	47.1	55
2009	Roche	Genetech	Acquisition	44.0	51

Bristol-Myers Squib to acquire Celgene for $95 billion

- Deal structure and relative share price performance

Ranked as one of biggest ever pharma deals, this deal consists of a cash-and-stock offer worth $95 billion including Celgene's debt, and has become one of the largest pharmaceutical deals ever and brings together two of the world's largest cancer drug businesses.

Based on closing price of BMS on January 2, 2019, the cash and stock to be received by Celgene shareholders is valued at $102.43 per Celgene share and one CVR which entitles Celgene shareholders a potential payment of $9.00 in cash upon FDA approval of three treatments (sclerosis drug ozanimod, lymphoma treatment and CAR-T therapy). Based on the 30-day weighted average price of Celgene, it represents a 51% premium (54% on January 2). Once completed, BMS shareholders will own roughly 69% and Celgene shareholders will own approximately 31%. The closing is expected to happen in the third quarter of 2019.

The transaction will not be subject to financing condition because the cash amount is a combination of cash owned and debt financing. BMS obtained the full commitment of the debt financing by Morgan Stanley and MUFG Bank. After the closing of the transaction, all debt of the combined entity will be pari passu.

BMS expects to achieve synergies of $2.5 billion by 2022. The deal aims at boosting earnings per share (Celgene shares skyrocketed by 33% while BMS fell by 10.3%.

Additional plans and actions based on this transaction are the followings:

- Accelerated Share Repurchase Program: $5 billion subject to closing of the transaction
- Corporate Governance: Dr Cafario will remain CEO and Chairman of the board and two members from Celgene's board will be added to the board of directors of BMS.
- Approvals and Timing to Close: subject to shareholders and regulatory approval, expected closing during the third quarter of 2019.
- Advisors: Morgan Stanley & Co. LLC is serving as lead financial advisor to Bristol-Myers Squibb, other advisors are Evercore and Dyal Co. LLC. Kirkland & Ellis LLP is serving as BMS's legal counsel. J.P. Morgan Securities LLC is serving as lead financial advisor and Citi is another financial advisor. Wachtell, Lipton, Rosen & Katz is serving as legal counsel to Celgene.
- Financing: BMS has obtained fully committed debt financing from Morgan Stanley Senior Funding Inc and MUFG Bank Ltd.
- Celgene and BMS will have to pay $2.2 billion if either of the drug makers walks away from their transaction, according to a regulatory filing.
- Celgene only sought for one other bidder, because the company aimed at a strong strategic fit and at a comparable competitive offer. When the other company said no, Celgene went for BMS, because outreaching additional firms would increase the risk of a leak.

- Financial summary of BMS

Bristol-Myers Squibb Company (BMS) is a global biopharmaceutical company. The company is involved in the discovery, development, licensing, manufacturing, marketing, distribution and sale of innovative medicines in various therapeutic areas. The company operates across the Americas, Europe, Asia, Australia, and other regions of the world. BMS is headquartered in New York City.

The company reported revenues of $20,776 million for the fiscal year ended December 2017 (FY17), an increase of 6.9% from FY16. In FY17, the company's operating margin was 25.2%, compared to an operating margin of 30.6% in FY2016. In FY2017, the company recorded a net margin of 4.8%, compared to a net margin of 22.9% in FY2016. The company reported revenues of $22,561 million for FY18, an increase of 8.6% from FY17.

Figure 4: Main revenues of BMS and forecasts

In Millions of USD except Per Share 12 Months Ending	FY 2017 12/31/2017		FY 2018 12/31/2018		FY 2019 Est 12/31/2019		FY 2020 Est 12/31/2020	
Revenue	**20 776,0**	**100,0%**	**22 561,0**	**100,0%**	**24 648,5**	**100,0%**	**27 105,0**	**100,0%**
BioPharmaceuticals	20 776,0	100,0%	22 561,0	100,0%				
Opdivo	4 948,0	23,8%	6 735,0	29,9%	7 466,5	30,3%	8 318,8	30,7%
Eliquis	4 872,0	23,5%	6 438,0	28,5%	7 741,2	31,4%	8 910,0	32,9%

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- Financial summary of Celgene

Celgene produces and sells novel therapies for the treatment of inflammatory diseases and cancer. It sells these products through wholesale distributors and specialty pharmacies in the US and its international sales are made directly to hospitals, clinics and retail chains. The company operates in the US, Europe and other countries. The company is headquartered in New Jersey, the US.

The company reported revenues of (US Dollars) US$13,003 million for the fiscal year ended December 2017 (FY2017), an increase of 15.8% over FY2016. In FY2017, the company's operating margin was 35.9%, compared to an operating margin of 25.1% in FY2016. In FY2017, the company recorded a net margin of 22.6%, compared to a net margin of 17.8% in FY2016.

The company reported revenues of US$3,892.0 million for the third quarter ended September 2018, an increase of 2% over the previous quarter.

Celgene expects full-year earnings in the range of $10.60 to $10.80 per share, with revenues in the range of $17 billion to $17.2 billion.

Celgene shares have risen 37 percent since the beginning of the year, while the Standard & Poor's 500 index has climbed roughly 7 percent. The stock has declined 13 percent in the last 12 months.

Figure 5: SWOT analysis of both companies involved in the deal

SWOT Analysis	*Bristol-Myers-Squibb*	*Celgene*
Strenghts	Robust R&D structure helping BMS strengthen its product pipeline strong alliance and collaboration network for drug development and commercialization inorganic growth helped BMS strengthen its biopharmaceuticals business	Enhanced R&D capabilities helping Celgene bring new therapies to market Strong market performance of Revlimid, Pomalyst/Imnovid and Otelza helping Celgene sustain leading position in oncology market
Weaknesses	Litigations may dent the company's brand image, decreasing sales in its product lines	Significant dependence on the US for majority of revenues
Opportunities	Approvals to expand BMS's products clinical research collaboration agreements and external growth through acquisition	Acquisitions could further strengthen Celgene's market position Strategic launches and agreements
Threats	Delayed launches could negatively affect the company's business increased pricing pressure changes to product labelling for the company's marketed products may affect its revenues	Issues with Government regulations and Policies Consolidation among drug wholesalers could increase pricing pressures

Rationales of the Deal

- Strategic reasons:
  - Efficient capital allocation for R&D and manufacturing: As discussed before, the costs of development for new drugs are extremely high and big companies tend to perform poorly because the complex organization and decision-making process is not adapted to foster innovation. Therefore, a lot of acquisitions are realised by acquiring entrepreneurs' companies and helping them fund the research and development at an early stage of the project. In this sense, M&A is the norm in the pharma industry to reach out for innovations.
  - As a source of innovation: M&A is used to access innovation by big companies. Indeed, shares of revenues from innovation sourced from the outside firm represents on average 50% in the recent years. The development of a new drug requires huge early-stage investment, which represents often a low probability of success. These dynamics create an industry profile in which smaller, creative companies end up funding innovation. Once their research becomes more advanced, larger pharmaceutical companies start to intervene.

- ➢ To realign portfolios: Large pharmaceutical and biotechnology companies often engage in deal making to realign their portfolios – either due to their changed strategy or their searching for ways to bolster their commercial pipelines.

Christoph Franz, chairman of Roche Holding AG, believes that this deal will lead to improvement in the oncology sector. He added that it was necessary to put more efforts to get a better medicine in the future.

There are many strategic benefits. Both franchises have complimentary portfolios (especially in oncology) which enhances global reach and scale. The outcome is believed to be a company with nine products of more than $1 billion in sales per year with growth opportunities. These new products will increase BMS's capabilities and improve its market position and differentiate products. For the future, the merged entity expects to launch six products over the next two years, five of them are from Celgene's pipeline.

The combined company will have solid early-stage pipelines to sustain growth and value creation with revenue potential of $15bn. In Giovani Caforio, Chairman and CEO of BMS, own words, "Together with Celgene, we are creating an innovative biopharma leader, with leading franchises and a deep and broad pipeline that will drive sustainable growth and deliver new options for patients across a range of serious diseases. As a combined entity, we will enhance our leadership positions across our portfolio, including in cancer and immunology and inflammation. We are impressed by what Celgene has accomplished for patients, and we look forward to welcoming Celgene employees to Bristol-Myers Squibb. Our new company will continue the strong patient focus that is core to both companies' missions, creating a shared organization with a goal of discovering, developing and delivering innovative medicines for patients with serious diseases. We are confident we will drive value for shareholders and create opportunities for employees."

- Financial reasons:
  - ➢ To unlock synergies from top-line revenues, SG&A, reduction of R&D budgets and manufacturing.
  - ➢ To understand how US tax reform will affect divestitures: in the early 2000s, the companies that made the biggest deals created the most value; synergies paid for the deal premium. More recently, however, the pharmaceutical companies that have been more selective in their deal making, and those that have supplemented even small deals with partnerships and licensing agreements have created the most value. The premium on innovation is big, and those who place the most bets are rewarded.
  - ➢ To cut R&D cost: ever-increasing cost of R&D and drug development has an average total cost of $2.6billion. Due to progress in medicine new drug needs to be either completely new or significantly better and be subject to up-to-date regulatory requirements.

In this case, financial motives play an important role too. Last year both firms lost a lot in market capitalization, BMS fell 15.2% and Celgene 40%. BMS revenues are mainly generated by Opdivo, a cancer treatment, which is currently facing high competition from Merck & Co's. This transaction highlights the concern of BMS towards its main drug. In addition, shareholders are also concerned about the profitability of future drugs in development in order to offset the loss of exclusivity for some major products in 2022 and 2026. Despite this, Revlimid gives BMS enough margin to pay down debt, by generating about $10 billion last year.

The Internal rate of return of the transaction is expected to surpass (40%) cost of capital of both companies. In addition, this operation will strengthen the balance sheet as well as cash flows: more than $45 billion of FCF over the first three years. The new entity aims to maintain a strong credit rating while continuing its dividend policy for the benefit of both companies' shareholders. The overall cost synergies are expected to be $2.5 billion by 2022 and BMS is confident about this goal while continuing to achieve strong efficiency and commitment to innovation and development. Half of the synergy is coming from cuts in SG&A expenses, and 35% would be from reduction of the R&D budgets and 10% from manufacturing. The deal is believed to add 40% to the company's earnings in the first year following the closing of the deal, scheduled for the third quarter of 2019.

Concerning due diligence, even though Celgene may be facing big patent cliffs, Giovani Caforio is confident on the work realised in Celgene's pipeline. He is "comfortable in the quality of the assets, the depth and breadth of the opportunities, so we feel really good about what we are acquiring."

The companies said they did not anticipate any antitrust issues impeding approval for the merger, given the complementary nature of their assets.

The deal is also an exit for Celgene CEO Mark Alles, who did not succeed at creating value for Celgene. The company lost more than half of its market value since October 2017 due mainly to the big failure of Crohn's drug.

Some analysts believe that this transaction coming early in 2019 is the beginning of a new era of mega deals in the industry, after the 2009 wave.

Conclusion

This deal is quite controversial, despite the strategic and financial motives behind it, the amount seems extremely high. One reason that brings concerns is the poor performances of the firms for some of their star products. Is this acquisition the best way to join the "big league" or does it hide some difficulties? There are some reasons for optimism, with a lot of products in the pipelines and the complementarity of both firms. However, shareholders are reacting quite hectically, which brings doubt on the future outcome of possibly one of the biggest deals in history.

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