PART II: NEW TRENDS RESHAPING HEALTHCARE M&A: INTELLECTUAL PROPERTY (IP)

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The first article of this three part series talked about the trends in M&A activity around Healthcare companies where real estate is a major portion of the company's assets. In this second article, we examine how the development and acquisition of IP influences trends in the broader Healthcare M&A market.

Whether it's a large pharmaceutical firm trying to expand its drug pipeline or an upstart eHealth company developing the next great consumer-focused digital platform, intellectual property (IP) continues to drive merger and acquisition deals in the healthcare sector. The acquisition of IP often requires a smaller investment in time and capital than a typical research and development cycle, and also lessens the risk of developing products that never achieve commercial viability.

HOW IP IS INFLUENCING BIOTECHNOLOGY M&A

Few healthcare markets are as active as biotechnology in terms of M&A activity. The biotech market is near the top of the healthcare sector in total number of transactions and dollars spent, even though deals are down more than 50 percent from the 153 recorded between 2007 and 2010. During that period the market was given a jolt by a massive deal that saw Roche Holding AG buy the remaining part of Genentech it didn't yet own for nearly $47 billion. That deal alone represented half of the dollar value of total biotech transactions in 2008.

The buyer profile for most biotech firms is consistent: large pharmaceutical companies. This is not likely to change, as "Big Pharma" pursues an inorganic growth strategy based on the idea that developing new drugs (most of which ultimately fail) is simply more expensive than buying smaller companies further along in the product development cycle. Acquiring IP is often more efficient than spending billions on research and development with no guarantee of success.

Biotech IPOs reached a five-year peak in 2014. This development led to an increase in the number of acquisition targets in the space, as proven results is often a prerequisite before a company will go through the costly IPO process. Additionally, this has bolstered valuations in the biotech sectors as public companies have been receiving acquisition multiples significantly above their IPO values, as well as a greater amount of funds upfront, when compared to private companies

continued on page 2

Venture capital has been flooding the biotech market, as investors scramble to identify the next breakthrough medication. Companies developing new treatments for diseases such as cancer or liver disease are especially attractive as such treatments are more likely to be profitable. Private equity, however, has largely stayed on the sidelines. The development cycle of many biotech products is too long for many private equity investors. Additionally, the risk involved is too high as most products never achieve commercial viability.

THE IMPACT OF IP ON EHEALTH M&A

Distinct from other healthcare markets in that it involves digital technology rather than any sort of patient care, eHealth has come a long way since the market was devastated by the dot.com bubble. Early-stage eHealth technology was ahead of its time; consumers simply weren't ready to use many of the services.

However, attitudes have changed in the last 15 years. The market for the products has matured, and the technology has become vastly more useful. Digital medical records, proprietary data analytics, and the development of health care platforms offering a "retail experience" for the consumer have all helped drive growth in the market.

While eHealth acquisitions tend to be small, the market has picked up considerably since its previous peak in 2009. The total dollar value of all acquisitions in 2014 was nearly double that of 2013, thanks in part to a pair of sizeable transactions. Cognizant Technology Solutions bought TriZetto Corporation for $2.7 billion, while Siemens AG sold its health information technology division to Cerner Corporation for $1.3 billion. The pursuit of IP plays a significant role in eHealth M&A, as many deals are driven by the desire of larger companies to acquire potentially transformative technology, particularly with regard to improving the consumer experience.

THE INFLUENCE OF IP ON MEDICAL DEVICE M&A

The implementation of the Affordable Care Act (ACA) was widely expected to have profound implications for the medical device M&A market. The ACA resulted in a devastating new 2.3 percent excise tax on products, which resulted in a significant decrease in the number of deals, as many underfunded and unprofitable startups struggled to survive in the new landscape. This development could have long-lasting effects, as larger companies seeking to acquire IP are forced to deal with a depleted pipeline due to this contraction. It should be noted, however, that the political future of this tax is uncertain; there have already been legislative attempts to eliminate it.

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Despite all of this, the year 2014 saw the largest acquisition in the history of the medical device space, when Medtronic purchased Covidien for $42.9 billion. Though such massive deals draw the most attention, most transactions in the medical device space are small. Many deals involve one private company buying another, or a public firm buying a private company for certain assets or patents. It is possible that smaller manufacturers will drive future deals, as they seek to secure new IP in an effort to differentiate their product lines from larger companies.

HOW IP INFLUENCES PHARMACEUTICAL MARKET M&A

The pharmaceutical market has long been the prime mover and shaker in the healthcare M&A market. Pharmaceuticals lead the healthcare sector in terms of deal numbers and dollars spent, as drug companies' feast on biotech firms in an effort to acquire IP. This is highly unlikely to change, as the failure of multiple high-profile clinical trials has served as an impetus for more activity, with companies seeking to acquire IP to replenish their depleted drug development pipelines. The Food and Drug Administration's new fast-track approval process is likely to spur even more activity.

The number of large deals in the market has been particularly high recently, with three of the 10 biggest deals of the last 15 years announced in 2014. In the first quarter of 2015, two more prominent deals were announced: Valeant Pharmaceuticals International Inc. bought Salix Pharmaceuticals for $15.8 billion, and Pfizer acquired a division of GlaxoSmithKline for $17 billion. These numbers don't include Pfizer's failed $118 billion bid to by AstraZeneca, a mega-deal even by this market's elevated standards.

continued on page 3

Given the pharmaceutical industry's continual need for a diversified pipeline of new products—and the potential for lower development costs—sustained M&A activity in the market is highly likely in the years ahead.

THE IMPORTANCE OF IP DUE DILIGENCE WHEN NEGOTIATING A DEAL

It is vitally important to fully understand the intellectual property assets of an acquisition target, whose transaction value can reach into the billions. Without a thorough understanding of the complexities of these high-stakes transactions, it's virtually impossible to derive precise valuation numbers when negotiating a deal.

Some key IP due diligence steps include:

- Trademark searches and filings: A necessary step to locate trademarks, revealing their existence and currency.
- Copyright searches and filings: Allows for the verification of ownership, registration and scope of a copyright, and alerts buyers to any copyright licenses and misuse.
- Patent searches and filings: Exposes a patent's validity, enforceability and prosecution events that can alter a patent's claims.

THE TAKEAWAY

Whether it's a pharmaceutical company seeking to acquire new drugs, or a medical device company seeking new technology to differentiate its product line, the pursuit of new and innovative intellectual property is one of the key drivers of healthcare M&A activity. As such, a full understanding of a target company's IP is critical to the ultimate success of any deal in this sector.

By completing the due diligence steps outlined above, deal makers can put themselves in the best possible position to derive accurate valuations—and conclude successful transactions.

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