Executive Insights

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Are Big Deals Back in the Brazilian Pharmaceutical Market?

In the late 2000s, the Brazilian Development Bank established Profarma, a program with a line of credit intended to create a Brazilian national super-pharma company. But Profarma did not deliver. This *Executive Insights* will examine how economic recovery, new regulations and competition will drive the future of Brazil's pharmaceutical market.

Many of the pharma company mergers and acquisitions that have happened over the past 15 years have been possible because of two landmark events that happened in 1999, well before Profarma existed: the establishment of the National Health Surveillance Agency of Brazil (ANVISA) and the passage of the Generic Drug Act. These events enabled the market to create new, big-league national winners, including NC Farma (EMS), Eurofarma and Hypermarcas. Companies such as Pfizer (through its acquisition of Laboratório Teuto) and Sanofi-Aventis (through its acquisition of Medley) also joined the party (see Figure 1).

The many mergers and acquisitions created not only a group of commoditized, stressed companies but also an entire industry in need of reform. Value migrated to the recently consolidated retail side of pharmaceuticals. Raia Drogasil, the retail market leader, subsequently appreciated substantially, given the power shift to retailers in generics and other trade-dependent categories (see Figure 2).

A few national laboratories (e.g., Aché, Biolab, Libbs) have remained firm in their purpose of generating physician-based demand, and this model has served them well.

Other national companies are trying to move into this model, with only one recognizable success: Eurofarma. Even Hypermarcas, with its successful restructure in order to focus on pharmaceuticals, focuses primarily on over-the-counter (OTC), where trade deals are driving growth and results, but at ever-reduced margins.

Finally, there are companies that originally were smaller and focused on Similares (branded copies), but are now in a dire situation or have been sold. The ones that were lucky enough to be sold to a multinational are most likely going to be divested, as just happened with Delta, formerly owned by Valeant. These companies will have to find their way in a very tough market.

Trends shaping the future

The current market state is by no means the end game. The following trends are opening up potential for consolidation:

- Increased regulatory costs and standards
- Increased creative product innovation
- Therapy area competition
- Economic recovery

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Figure 1
Largest pharmaceutical transactions in Brazil

	Buyer	Target	Largest pharma transactions in Brazil (Buyer) USD MM
1.	Hypermarcas (2010)	Mantecorp	1,487
2.	Hypermarcas (2009)	Laboratorio Neo Quimica	751
3.	Sanofi-Aventis (2009)	Medley	680
4.	Hypermarcas (2007)	DM – Ind. Farmacêutica Ltda.	675
5.	Royal DSM NV (2012)	Fortitech Inc.	634
6.	Hypermarcas (2008)	Farmasa[1]	536
7.	Kinetic Concepts Inc. (2013)	Systagenix Wound Mgmt. Ltd.	485
8.	Merck & Co. Inc. (2016)	Vallee SA	400
9.	Lupin Ltd. (2015)	Medquimica Ind. Farm. SA	394
10.	Aché (2005)	Biosintética Farmacêutica	247
11.	Takeda (2012)	Multilab Ind. e Com. Prod. Farm.	246
12.	Amgen Inc. (2011)	Laboratorio Bergamo	215
13.	Hypermarcas AS (2010)	Mabesa do Brasil	199
14.	Hypermarcas AS (2008)	Niasi S.A.	183
15.	Hypermarcas AS (2009)	Pom Pom Produtos Higiênicos	169
16.	Pfizer (2010)	Laboratório Teuto	141

[1]Laboratório Americano de Farmacoterapia.
Source: EMIS

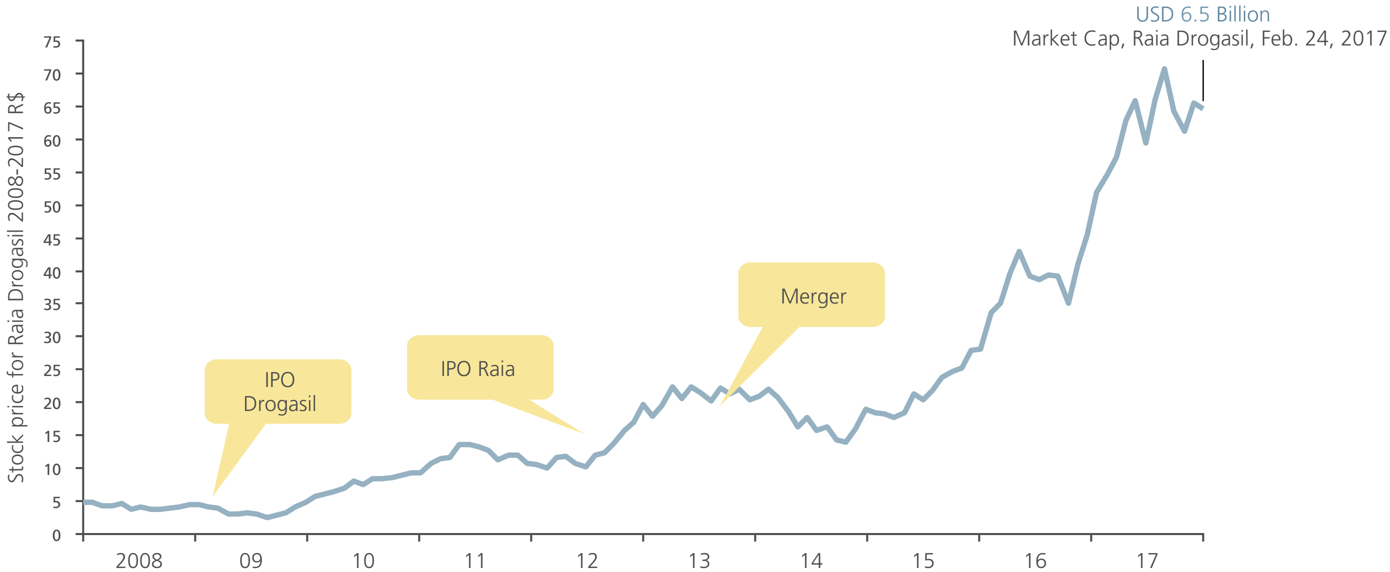
Unlike in 1999 or the late 2000s, when expected results did not come to fruition, strategic thinking will certainly play a bigger role this time around.

Commoditization has led to challenges to transfer pharma growth to the bottom line. Revenues of pharmaceutical retail for generic drugs grew 14.7% in 2016, whereas producer-level growth for generic drugs was only 10.4%.[1] Generics now account for 30% of the retail market.[2] Hypermarcas, the fourth-largest generics producer in Brazil, grew its generics sales 9.7% in 2016. These statistics reflect the retail sector's newly acquired market power, thanks to increased competition among generics manufacturers (the top three generics sold in Brazil have at least five competitors each). Although the registration process for generics, historically, has been time-consuming, it has not been expensive.

But that will likely change. ANVISA has been stepping up regulations and will increase renewal costs dramatically.[3] In this environment, sustaining a portfolio of more than 100 pharma products is no small task; certain capabilities are required just to compete. Additionally, quality standards and Good Manufacturing Practice requirements have increased in stringency over the years, requiring companies to invest in their production and quality structures continuously. **Three forthcoming trends are emerging: There will be fewer registrations, labs with small portfolios will not be able to sustain their costs and consolidation will be incentivized.**

As mentioned previously, the retail sector is in the process of consolidating,[4] and multiple companies (e.g., Grupo Ultra, Patria Investments, General Atlantic) are trying to capture the opportunity. Generics are discounted at 70-75% — and at an increasing rate — excluding other trade arrangements, such as marketing investments at the trade level. Fueling the retail generics machine is the fact that the majority of the sector's value is in the hands of fewer large buyers, such as Raia Drogasil, Pague Menos, Drogaria São Paulo/Pacheco and other regional companies. Another relevant factor is in distribution, with Santa Cruz's acquisition of Panfarma, given that these are the two largest distributors in the business. **Clearly, consolidation at the producer level is needed to balance retailers' and distributors' power.**

Figure 2
Value creation for retail market leaders



Sources: Raia Drogasil, Capital IQ, Bloomberg, L.E.K.

The pharma industry is trying to balance this power by making more investments in innovation. Hypermarcas announced it is investing in innovation[5]; Aché has a total of 42 patents, followed by nationals Biolab and Cristalia, with 34 and 33 patents, respectively (these two companies collectively hold eight patents in pharmaceutical applications of nanotechnology[6]). Aché also has 15 projects in radical innovation under development. The size and the risk nature of pharmaceutical development projects mean that scale is a requirement. **This is yet another incentive for consolidation.**

Another theme of competition that involves consolidation is the move to demand-driven (physician-driven) markets. Multinational companies and two national players (Aché and Eurofarma) are the leaders in this space. Multinational companies are globally focusing on greater growth through fewer therapy areas. Consequently, there have been many portfolio deals as multinationals divest mature lines. **The rearrangement of therapy-class-based competition is another relevant driver of acquisitions and consolidation.**

Pharmaceuticals in Brazil are a robust business for the larger players. Even under the deepest recession in the country's history, which resulted in a 3.6% decline in GDP, pharmaceuticals managed to grow approximately 7% from 2015 to 2016.[7] The underlying fact that aging, obesity and new products continue to drive medical needs is not subject to the variations seen in other sectors (see Figure 3). Pharmaceuticals are a cash-generating business that offers attractive returns. Companies have a lot of cash in their balance sheets, plus strong margins, so the ability to make deals will increase as the economy drives further growth. **The incentive for M&A deals is increased with the cash-rich and growth options available.**

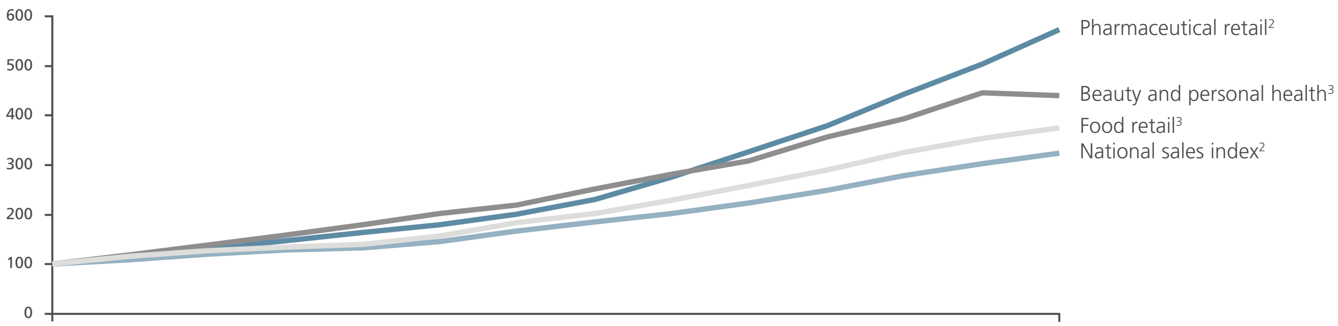
The consolidation opportunity

The Hypermarcas transactions in the mid- to late 2000s showed that consolidation is both profitable and possible. With high multiples as a basis, Hypermarcas, virtually the only listed pharmaceutical company in the country, had access to the proper currency — shares — to buy and consolidate assets, so it could offer shareholders the option to exit or diversify, and therefore it became a platform for consolidation.

With four large acquisitions (over the course of four years), Hypermarcas transformed itself from a consumer products company to a pharmaceutical business focused on OTC drugs. It now shares the leadership in that segment with France's Sanofi-Aventis. Together, the companies have approximately 30% of the OTC market and full portfolios of solid brands. But Hypermarcas

Figure 3
Pharma versus other sectors

Comparison of growth in different sectors[1] — Brazil
(2002-2015)
Base-100: 2002



[1]Size of sectors in nominal values. [2]Retail prices; does not consider special drugs. [3]Factory prices.
Sources: ABRAS, ABIA, ABIHPEC, Apresentação Institucional Raia Drogasil (IMS)

did not go much beyond OTC, and its various other subsegments are not yet at the same consolidation level as its OTC business.

The same logic can be applied to other segments, such as the larger prescription-driven business, with the addition of multiple value synergy opportunities:

- **Sales force scale.** Many options exist for consolidated companies: high share in specific areas (e.g., cardio has two or three main national players, and central nervous system has four large national players).

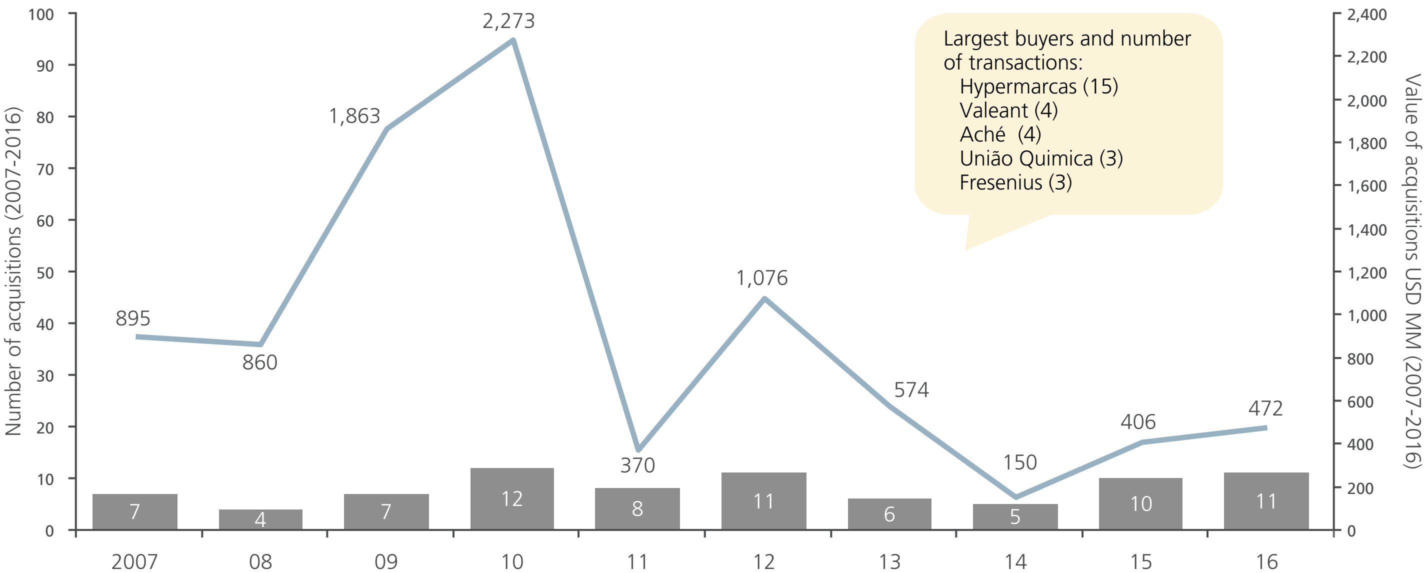
How to think strategically about consolidation

Between 2007 and 2016 (see Figure 4), pharma companies closed many deals, but many of these assets are now for sale because the companies in the transactions did not ensure strategic fit. To avoid a similar fate, companies today should think about a strategy that addresses inorganic growth. They would be wise to address the following themes:

- **Understand your position, and set goals.** It is critical to determine the feasibility of the transaction and the current strengths of the business. Choices are critical at this stage. Do you dominate a single therapy area, or are you diversified? Is the business in a competitive standing, or does it lack significant share?
  - a. Build an honest understanding of your market position
  - b. Determine how changing the market structure can favor your position
  - c. Understand your value
  - d. Set strategic inorganic growth objectives
- **Build options.** Inorganic growth is a tricky business. Potential partners often do not favor these deals, so you need options.
  - a. Select rational assets that fit your strategic goals
  - b. Identify synergies
  - c. Map impact in your market structure
  - d. Consider cultural fit, risks and dilution potential
- **Select preferred target.** Choose the potential partners you prefer to address first, and then test their interest in potential deals.
  - a. Choose two or three potential deals
  - b. Test interest, and share goals
  - c. Quantify synergies and other implications
  - d. Design the transaction

Finally, when deals get to closing, be sure to have a post-merger plan, including a blueprint for the future business position and strategy, in place. Many deals in the pharma sector in Brazil have had poor outcomes due to a lack of forethought. Thinking strategically and practically throughout the journey can save a lot of trouble and a great deal of value.

Figure 4
History of pharmaceuticals M&A in Brazil



Sources: Análise L.E.K. de dados da EMIS

- **Marketing investments.** Consolidating budgets in areas such as congresses and events can provide a more effective use of resources.
- **Portfolio scope economies** can be exploited, which means higher frequency and reach are possible.
- **Innovation scope and scale**. As the business gets bigger, innovation can be a source of value and project rationalization.
- **Market knowledge** and innovation in specific therapy areas are reachable and facilitated. A deeper presence in key therapy areas provides insights into unmet medical needs that will feed innovation.
- **Even negotiation** with the trade channels can provide opportunities, given the disproportionate power retailers have been able to accumulate.
- **Rationalization of production and distribution assets.** Plants, production lines, quality and regulatory are all areas subject to synergy gains.
- **The creation of platforms.** The first companies to establish themselves as platforms will get to choose the most interesting assets.
- **Pure consolidation.** Areas that face enormous challenges, including generics, may experience a much better environment if they shape the market using the inorganic growth lever.
- **Taxes.** Potential tax implications of deals, such as holding assets in tax-advantaged areas and using goodwill depreciation, can drive significant value. Tax advantages should not be the sole driver of decisions, but they must be understood as a relevant addition to a potential deal.

All these value synergy opportunities require structured and disciplined thinking regarding how to fit assets together in a coherent way.

Who can win?

Brazilian companies have a unique opportunity to seek consolidation in selected therapy areas, or using commercial scale to balance retailer power as well as driving medical prescription and adherence. Consolidation and synergies can be driven to innovation efforts, particularly incremental innovation. There are recent examples that show how driving innovative solutions in unmet medical needs will drive the future.

Multinational companies have diverse strategies. For the global companies that are focusing on specialty products, a robust market for assets to divest can facilitate transformation. Some companies are advanced in this respect (e.g., Bristol-Myers Squibb), but others still carry a local portfolio that may not be in their long-term interest. Likewise, companies such as Pfizer and Abbott maintain an interest in a mature portfolio. For these companies, the opportunity is right at their door.

Sources:

1. Análise Progenéricos a partir de dados IMS Health
2. MarketLine
3. RDC 73 and RDC 76 — Anvisa regulations
4. Raia Drogasil institutional presentation
5. Valor Economico, Dec. 6, 2016
6. INPI — Instituto Nacional da Propriedade Intelectual
7. EMIS report on Brazil Pharmaceuticals & Healthcare (2017)

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