Daiichi sankyos ranbaxy acquisition analysis

With the spiraling up healthcare charges and government expenditure on public healthcare, many developed countries are trying to promote generic drugs. The demand for generics is also complemented by wider access to healthcare in developing economies. This coupled with the expiry of many patented drugs around the corner, many brand name pharmaceutical companies tried to acquire generic drug companies, in this paper we try to analyze one such acquisition.

On 11th June 2008, Daiichi Sankyo the third largest pharmaceutical company in Japan made an offer to buy control stake in Ranbaxy, the largest drug-maker by revenue in India. The purchase price of INR737 represented a premium of 53. 5% over Ranbaxy’s average daily closing price on the National Stock Exchange for the three months ending on June 10, 2008 and 31. 4% over closing price on June 10, 2008.

In this paper we would analyze why Daiichi Sankyo must have picked Ranbaxy and Daiichi’s Strategy behind the acquisition. We also try to do the valuation of Ranbaxy at the acquisition time and whether Daiichi paid a hefty premium over its intrinsic value.

Post-acquisition Daiichi Sankyo’s stock moved southwards, later in this paper we try to address this shareholder reaction. The acquisition was termed bad and Daiichi had a one-time writing down of $3. 45 billion off its balance sheet. We also analyze what might have gone wrong in this cross-border transaction, issues such as lack of proper due-diligence on Daiichi Side and lack of transparency on Ranbaxy side.

INTRODUCTION

The pharmaceutical industry develops, produces, and markets drugs licensed for use as medications. Pharmaceutical companies can deal in generic and/or brand medications and medical devices. They are governed by a variety of geography specific laws and regulations regarding the patenting, testing and ensuring safety and efficacy and marketing of drugs.

Its origins can be traced back to the nascent chemical industry of the late nineteenth century in the Upper Rhine Valley near Basel, Switzerland when dyestuffs were found to have antiseptic properties. Many of the modern pharmaceutical companies started out as Rhine-based family dyestuff and chemical companies e. g. Hoffman-La Roche, Sandoz, and Novartis etc. Over time many of these chemical companies entered into pharmaceuticals business and gradually evolved into global players. The industry expanded rapidly in the sixties, healthcare spending skyrocketed as global economies prospered in this period. In the seventies the industry evolved further with the introduction of tighter regulatory controls, especially with the introduction of regulations governing the manufacture of ‘ generics’. The new regulations abolished permanent patents and allowed patent protection for branded products for fixed periods only, and a new competitive segment ‘ branded generics’ evolved in the pharmaceutical space.

With the patent expiries of many blockbuster drugs nearby and increasing demand for cheaper drugs, many pharmaceutical companies are trying to offer a generic drug portfolio as well. The fastest way to add this portfolio is the inorganic way; let’s look at one such case wherein a Japanese

Pharmaceutical giant acquired a large bracket Indian Generic drugs company.

Daiichi Sankyo before Acquisition (Year ending March 2008)

Daiichi Sankyo was Japan’s 3rd largest pharmaceutical company, established by the merger of Sankyo Co., Ltd. and Daiichi Pharmaceutical Co., Ltd in September 2005. Daiichi was mainly a brand, R&D oriented pharmaceutical company with revenues of 880 billion yen ($8. 8 billion) in FY 2007-08. The company was cash rich and had around ¥574 million in cash and cash equivalents. Its portfolio comprised of pharmaceuticals for hypertension, hyperlipidemia, and bacterial infections, the Group was also engaged in the development of treatments for thrombotic disorders and focused on the discovery of novel oncology and cardiovascular-metabolic therapies.

With the shrinking Japanese market the company had a clear inclination towards overseas sales, the Overseas Sales/ Net Sales had steadily increased from 33% to 40% from 2005-2008, however markets other than the traditional Japan and North America were the ones which were showing real movement. The company clearly aimed to build Asia, South and Central America markets. Daiichi already had business operations in 21 countries and aimed to be a Global Pharma Innovator by 2015. In India they were already underway forming a Sales subsidiary. The Company also was trying to concentrate on its core pharmaceutical business by spinning off non-pharmaceutical businesses from the group.

One of the mid to long-term goals of Daiichi was to increase its presence in novel therapeutics in oncology arena; on these lines they also acquired a German company named U3 Pharma AG.

Ranbaxy before the Acquisition (Year Ending December 2007)

Ranbaxy Laboratories Limited, India’s largest pharmaceutical company, was an integrated, research based, pharmaceutical company producing a wide range of quality, affordable generic medicines, used across geographies. The Company than served customers in over 125 countries and had an expanding international portfolio of affiliates, joint ventures and alliances, operations in 56 countries.

Ranbaxy’s revenues and bottom lines were continiously on the rise since 2001, the R&D expenses were stable around 6%. In FY 2007 the company had revenues of 69, 822 million INR ($1. 5billion) excluding other income. The earnings of the company were well diversified across the globe, however the emerging world contributed heavily to the revnues (Emerging 54%, Developed 40%, others 6%). However the Japan market, with low generics penetration contributed just $25 million to the top line. The company had just begun to re-orient its strategy in favour of the emerging markets.

Ranbaxy had been on shopping spree in the previous year acquiring BeTabs South Africa, additional stake in Zenotech Laboratries, 14. 9% in Jupiter Biosciences India and 13 Dermatalogy products from Bristoll Myers Squibb in the USA. The company was still open for acquisitions and growth through inorganic activities. To take advantage of the upcoming R&D outsourcing

story Ranbaxy also demerged the New Drug Discovery Research under Ranbaxy Life Science Research Limited (RLSRL). Ranbaxy also had developed great partnerships with companies focused on research and manufacturing in speciality and niche areas, two of which were collabrative research programs with Glaxo Smith Kline. Ranbaxy also had signed some exclsuive inlicensing aggrements with Global companies, Sirtex Australia being one of them. To optimize its First to File (FTF) opportunities and hence ensure the revenue flows, the company entered into 3 independent litigation settlments with GlaxoSmithKline (GSK) for Valacyclovir and Sumatiptan and with Astellas Pharma for Tamsulosin.

The company entered into segments such as Bio-generics, Oncology, Penems, Limuses, Peptides, etc. due to the high potential they offered. On the operational front too the company was aggressive and had reduced the working capital by almost 3% of sales. The company undertook the modernization and capacity expansion in plants in India, Romania, Malaysia, Nigeria and South Africa. The company also discontinued operations in some of their inefficient plants in India.

The product, patent and API portfolio of the company was strong. The company made 526 product filings and received 457 approvals globally (Annexure A gives a detailed overview of the product, API and Patents in 2007). The company also continued its effort to develop effective herbal drugs that could comply with international quality standards.

The Deal

On 11th June 2008, Daiichi Sankyo made an offer to purchase more than 50. 1% voting right in Ranbaxy which included 34. 83% stake of promoters, preferential shares and an open offer. Daiichi offered a share price of INR 737 with a transaction value of around $4. 6 billion, valuing Ranbaxy at $8. 5 billion. Daiichi ended up acquiring 63. 92% shares of Ranbaxy by Nov, 2008 (details are provided in Annexure B). Including transaction costs the deal costed Daiichi $4. 98 billion (details are provided in Annexure C) and they recorded goodwill of $4. 17billion (details are provided in Annexure D).

For Daiichi Sankyo, in addition to the traditional high-risk/high-return business model employed in developed-country markets, Ranbaxy's generic business model would help them build a " hybrid business model" with a mix of patented and generic drugs. The deal also required the current CEO/Promoter Malvinder Singh to stay with the company for 5 years.

The deal financing was through a mix of debt and existing cash resources of Daiichi Sankyo. With the acquisition Daiichi got access to Ranbaxy's basket of 30 drugs for which the company had approvals in the US, including 10 drugs for which Ranbaxy had exclusive sales right to sell for six months after the expiry of their patents. The deal gave Daiichi an access to best FTF 180 day exclusivity pipelines in the industry. Ranbaxy had already de-risked its FTF pipeline through a series of settlement with innovator companies; this in-turn lowered the litigation expense and removed uncertainty with regard to the launch date of these generic drugs. It also helped in better planning of inventory, launch quantities and supply agreement.

DAIICHI'S GAIN FROM THE DEAL

The era of Generic drugs

Most of the pharmaceutical companies in developed world have been concentrating on the patented drugs market, and hence were more R&D oriented. But recently the generic drugs market has received more attraction because of:

Dates of patent expiry of blockbuster drugs discovered during 1990s are nearing

Governments and Insurers are encouraging use of generic drugs to control the spiraling up healthcare costs

With saturation occurring in the developed markets, the major markets now are the emerging countries. However the earnings of the citizens in these nations are not high enough to buy the costly patented drugs, so generic low-price drugs form a majority part of the drug markets in these countries. These Pharmerging nations were forecasted to account for the biggest share of pharmaceutical industry growth over 2008-13 period, it was supposed to be a $160-190bn market by 2013. However majority of multi-national pharmaceutical companies were underpenetrated in these markets.

With this changing market dynamics Daiichi made the decision to acquire a generic drug manufacturer from second largest populated country, India. This will help them establish presence in a new area (Generics) in the pharmaceutical value chain.

India: an emerging hub for Global Pharma

India in 2008 had gained a respected place in the in the space of Contract Manufacturing, Drug Development and Drug Discovery and Research. This had become possible due to a strong stream of talent flow, compliance with quality and regulatory standards, distinct cost advantages both in manufacturing and drug development. India also had a large naive patient pool with some of the fastest patient recruitment rates and an innovation and original research engine. India’s strength in this space was reflected by its research collaborations with global Pharmaceutical Companies.

For Daiichi its R&D expenses and COGS stood at around 45% of the Sales, shifting the R&D and manufacturing to India made sense to operate in the highly competitive environment and address continuous pressures from government to reduce drug prices.

Access to new markets

Daiichi believed that realizing sustained business growth would need the expansion of its prescription drug business in advanced country markets along with tapping growth opportunities in developing countries.

Ranbaxy had a strong presence in markets such as Africa, where Daiichi had never ventured. By using Ranbaxy’s network, Daiichi Sankyo could more than double its global reach from 21 countries currently to 56. As growth would slow in the developed markets, Ranbaxy will give Daiichi a strong position to expand their businesses in emerging markets including India, China, Russia and Brazil. Emerging Markets was a strong geographic component of Ranbaxy’s revenues. India was undoubtedly the biggest

market that Daiichi would get access to now, the Indian market was supposed to triple by 2015 from its 2005 size. Ranbaxy with its strong distribution reach and excellent brand recognition was well positioned across the Indian metro and extra urban areas.

Collaborations and Subsidiaries

In order to optimize value at various points across the pharmaceutical value curve, Innovator Pharmaceutical and Generic Companies were moving from a competing business model to a collaborative one. On this front too Ranbaxy had strong collaborative projects with companies such as GlaxoSmithKline. Some of them were in Oncology space, Oncology being an area of focus both for Ranbaxy and Daiichi would greatly bolster its presence in this space.

Ranbaxy itself had made many acquisitions in previous 2 years, BeTabs Pharmaceuticals South Africa being the recent one. These acquisitions made Ranbaxy’s position stronger in the Pharmaceutical space.

Japan Markets

Due to government measures to curb healthcare expenditure, in spite of growing prevalence of lifestyle diseases and aging population the Japan market was growing only quantitatively but not value wise. This government control on pricing is rare in many Asian countries and USA, making Japan an unattractive market.

However in-line with encouraging the use of generic drugs, many Japanese hospitals were applying the diagnosis procedure combination (DPC) reimbursement system. The Japanese government was also making efforts to

restrain drug-related expenditures through systemic reforms as well as other factors such as drug price revision under the National Health Insurance (NHI) scheme. So generic drugs was surely a promising business opportunity in the Japanese markets, in fact in FY 2008 Ranbaxy registered a sales growth of 38% in Japan (Sales of $20 million). However Daiichi later formed a new company in Japan for handling its generic space in Japan, the strategic intent of this step is a bit doubtful to me.

OTC and Biogenerics

Given the focus on OTC drugs by both the companies, opportunities existed to expand OTC product offerings of both Ranbaxy and Daiichi across world markets.

Biogenerics was also a common interest area for both the companies, Daiichi had just acquired U3 pharma AG and Ranbaxy had acquired Zenotech in the Biogenerics space. Both of them could use each other's expertise in clinical trial design, relationship with regulators and marketing power in the US and the EU

RANBAXY'S VALUATION

We used simple DCF valuation methodology to valuate Ranbaxy stock in June 2008, with following assumptions:

Sales will grow at 12% for 10 years (McKinsey projections for Indian Pharmaceutical industry) and then slowed down to 8% for 5 years. In order to account for the losses caused due to FDA action against Ranbaxy we have lowered the growth rates for 2008 and 2009 to 10% because Ranbaxy had

made alternative arrangements through its US its subsidiary Ohm Labs in the US.

NOPAT Margin maintained at 14% for 10 years and then lowered to 10%.

The company is making continuous efforts to decrease the working capital so we assume they would decrease it till 25%.

The Net Long Term Assets to Sales ratio would fall down to 45%.

DCF Valuation

254. 6

FTF Value

106

Investment in Associates

5. 03

Total

365. 63

With these assumptions we came to a value of INR 254. 6 (details in ANNEXURE J, K); however this value does not incorporate the value the strong FTF pipeline that Ranbaxy had. This FTF pipeline is valued at around INR106/share (details in ANNEXURE E). Going further we also need to adjust the value for investment in associates (refer ANNEXURE F) for market value

wherever information is available. The effective price as per our calculation for Ranbaxy in June 2008 should be INR 365. 63.

This shows how much premium Daiichi paid above the intrinsic value of Ranbaxy, with an acquisition price of INR 737, they paid almost a premium of 100% over the intrinsic value. I think this was a huge premium for a friendly takeover, suggesting that Daiichi would take long time to enjoy the real benefits of this acquisition.

SHAREHOLDER'S REACTION

The market reaction to this announcement was positive only during the open offer period, post that both the stocks plunged to almost 50% of their pre-transaction values. In Feb 2009 in response to FDA's action against Ranbaxy share price of Ranbaxy was almost 1/3 of what Daiichi Sankyo had paid. Later the Ranbaxy stock moved up considerably but Daiichi was still trading a low levels.

To reflect the fact that the market price for the shares of consolidated subsidiary Ranbaxy was way lower than the acquisition price, Daiichi recorded ¥351. 3 billion one-time write-down of goodwill associated with the investment in Ranbaxy. This led to a considerable net loss for Daiichi in fiscal 2008.

The write down itself signifies that the shareholders money, the retained earnings were wiped out in this acquisition and hence the southwards movement of stock price was as expected. The market expectations from Daiichi were low due to this write-down.

WHAT MIGHT HAVE GONE WRONG?

In September 2008 the FDA sent Ranbaxy warning letters regarding current good manufacturing practice violations at two of its plants Paonta Sahib and Dewas and forced restrictions on the import of drugs manufactured at these plants. This banned the entry of almost 30 Ranbaxy products in the USA. In February 2009, FDA also invoked its Application Integrity Policy (AIP) against the Paonta Sahib facility. The FDA enquiry had started long back in 2006 itself. According to the FDA report, Ranbaxy’s quality control scientists took shortcuts on the stability tests for at least two major drugs. They conducted these tests on the same day or within a few days of each other, not over nine months as claimed by the company. The FDA also claimed that Ranbaxy had submitted manipulated data as a part of its application to market new generic drugs in the US, as well as kept hundreds of improperly stored samples in its factories in Paonta Sahib and Dewas.

This was partly to blame to the organizational structure of the company as well. Traditionally the analytical research and quality assurance (QA) departments always had firewalls between them; the QA department job was to keep a watch on the activities of the research unit. However in the recent past, Ranbaxy brought both departments together, encouraging the problems to stay confined within the walls of the company. Daiichi should have assessed the standard pharmaceutical organizational structure and also tried to estimate the full extent of the legal risk arising out of the US FDA letters. They should have asked for information on plant inspections done in 2006 and details of submissions made by Ranbaxy in defence. However the fact that a Japanese company like Daiichi decided to tackle the

issue when presented with the problem rather than spending time evaluating the risk, was really impressive.

Ranbaxy was said to have poor human resource practices, which led to high employee turnover. In research and development alone, four departmental heads had resigned in quick succession in the period just before acquisition. This phenomenon of resource attrition at Ranbaxy continued even after the acquisition. Mr Malvinder Singh the CEO and promoter of the company left the company in May 2009. In the original agreement he was to stay with Ranbaxy for 5 years after the acquisition. By leaving 4 years before the contractual date not only did he have to pay a hefty severance package but also raised doubt among foreign companies, looking for Indian partners. For a foreign company like Daiichi it was natural to rely on promoters and their team to continue running the company for a while.

Daiichi paid INR 737 for a company with an intrinsic value of just INR 365. This valuation glitch clearly demonstrates Daiichi’s lack of understanding of generic business. I believe inadequate due diligence was done considering the size, scale and scope of the deal, reflecting Daiichi’s inability in understanding of India and the generic world. I also feel Daiichi was not able to properly access the possible impact of the ongoing FDA enquiry. Ranbaxy was also to blame for not being transparent about the actual status of the FDA enquiry. One more prominent thing that Daiichi probably missed on was the continuously increasing debt levels of Ranbaxy.

The year of 2007 witnessed great currency volatility in response of unforeseen global financial crisis. Through 2007 until early 2008, INR steadily

appreciated against the US Dollar. From around levels of INR 44, it strengthened to about INR 39 with the market forecasting further appreciation. In order to de-risk export revenues Ranbaxy took derivative positions to protect against exchange volatility. However INR movement sharply reversed to the US Dollar in June 2008 sliding past the INR 50 mark in H2 of that year. Owing to these loss making derivative positions Ranbaxy recorded foreign exchange losses of INR. 10, 856. 24 million in 2008. Daiichi with its global expertise should have reviewed Ranbaxy's overseas investments, including derivative instruments with open positions.

There must have surely been cultural differences and management style differences between the two companies and they did not get enough time to handle these issues. In an interview Atul Sobti, CEO Ranbaxy said " The Japanese are very process-oriented. They have a tremendous respect for teamwork. On compliances and quality, there can be no compromises. And those are the areas that we need to work on. Culturally, those are also not our (country's) biggest strengths. We will be sharply focussing on these issues." Daiichi also realized the need of global management structure and hence building a global management structure with clear roles and responsibilities for all locations and functions was one of the strategic agendas for them.

I am also sceptical about the synergies achieved in the patented drugs space, because even after the acquisition R&D expenses for Daiichi had grown from 18. 6% to 21. 9% of sales. Should the synergies have been achieved, with the directing of R&D and manufacturing to India, COGS and

R&D expenses for Daiichi should have decreased or at-least remained stagnant.

CONCLUSION

Initially the Ranbaxy deal seemed a win-win, allowing both companies to use each other’s networks and technological power. The deal seemed very lucrative for Daiichi Sankyo due to the access to best FTF pipeline, access to the generics product line, access to new markets and an opportunity to diversify away from Japan into the emerging markets. However looking at the post acquisition financial statements of these companies we realize that this deal was a failure and Daiichi is trying its best to make the acquisition work in its favour.

In the immediate year after the acquisition Ranbaxy reported a loss of INR 9, 512. 05 million and Daiichi in spite of diversifying its geographic footprint booked a loss of ¥215, 499 million and they also made a onetime goodwill write-down of ¥351. 3 billion for investment in Ranbaxy. These losses were mainly rooted in Ranbaxy’s poor performance owing to the FDA ban and bad decision in hedging currency risks.

The pre-acquisition due diligence should have understood that Emerging markets are lucrative but corporate governance and integrity are surely not to be assumed in these markets. Valuations in these markets are way higher than their real potential and valuation in strongly regulated industries like pharmaceutical is strongly linked to regulations in the major markets. For the export oriented companies developed markets with stricter regulations are the main revenues streams due to higher margins; however the regulations

in these markets are stricter unlike merging nations. Ranbaxy also had ease in clearing the Indian drug regulations but failed to clear the US FDA regulations and hence its US subsidiary Ohm Labs had to pitch in.

Other factors such as top-management retention rates, organizational structure, internal firewalls and proper use of financial instruments to hedge risks should have been analyzed before the deal.