Consolidation in Animal Health: A Much-Needed Growing Pain

During the two decades ending in 2015, the top ten human pharmaceutical companies – Pfizer, Novartis, Sanofi, Roche, Merck & Co, Johnson & Johnson, AstraZeneca, GSK, Teva and Gilead – were involved in over forty merger and acquisition (M&A) activities. The main drivers for these consolidation events were related to increasing regulatory pressures, falling research and development (R&D) productivity and the expiry of many patents that covered some of the high-earner pharmaceuticals.

The results of these M&A activities have been viewed with mixed feelings. Observers have praised and lamented, but whichever side one falls on it was crystal clear that these mergers and acquisitions were needed. The reality is that R&D, especially for a pharmaceutical, is not cheap and regardless of how many dollars an entity can dedicate to research activities, there is only so much bandwidth within a single organisation to cover all the possible leads. In many cases it is faster and somewhat cheaper to pick up a relatively “de-risked” lead off-the-shelf through M&A activity. This, of course, is not saying that R&D costs are the only drivers, because clearly others exist and in many cases can be more compelling.

The animal health industry is a growth industry. This is indicated by revenues that grow faster than the overall economy, many new companies entering the market, rapid changes in technology and processes, growing customer acceptance of the products and growing demand and the increased speed with which new products are introduced to the market.

The estimated size of the animal health market is approximately 25 billion dollars, with the growth rate hovering at or slightly above 5%. The United States by far is the largest single animal health market and represents almost 50% of the total available global market. Spending in general is split about evenly between production animals and companion animals, with pharmaceuticals representing over 60% of the market share, followed by biologics at around 30%, and then medicated feed additives.

Within the US animal health market, the largest drug class by far is the anti-parasitics, which bring in over 30% of the total US animal drug revenue dollars and, together with vaccines, lead all other drug classes with double-digit growth rates. What is striking about animal health, and the most misunderstood fact about the corresponding market, is that blockbusters with billion dollar sales do not exist. Aside from a very small number of products (less than 15) which achieve sales of over one hundred million dollars each, the vast majority of products (over 99% of the total number of products) have sales of less than one million dollars.

The plethora of “small” products is only matched by the number of companies within this industry, which is estimated to be in the hundreds, with the crushing majority being small privately-held companies, with few or no products but a lot of heart and some great ideas. Furthermore, the animal health industry is peculiar in that the top 10 companies were until recently, or still are, divisions of larger global human health companies, seeing the world of animal health, for better or for worse, through the prism of human health. Together those top 10 companies account for over 80% of the animal health market value and still exhibit considerable overlap in their product portfolios.

Every industry moves through a consolidation curve as it matures. This is an unavoidable process. Recently, and following their human parent company examples and due to drivers that include the world’s growing, well-informed population, growing regulatory pressures, brand and market positioning, as well as the limitations associated with in-house R&D efforts, there has been a significant increase in M&A activity within the animal health industry.

Some of the most significant M&A activity occurred within the top seven animal health companies over the past 30 months. In early 2015, Eli Lilly closed a deal to acquire Novartis Animal Health as part of its animal health division, Elanco. The regulators approved the deal on the condition that certain US assets related to the Sentinel canine parasiticide are divested to other companies. In this case it wasVirbac, also a top 10 animal health company.

According to Eli Lilly, the combined organisation will help Elanco expand its global commercial presence, augment its manufacturing and research and development capabilities, and provide Elanco with a more balanced and diversified product portfolio between companion and production animal product offerings. The deal was an all-cash transaction of approximately 5.4 billion dollars. The combined company of the then number four (Elanco) and number seven (Novartis Animal Health) ranked companies became the number three ranked animal health company based on revenue.

Recently, Elanco closed another perceived gap in their product lineup by signing a deal with Aratana Therapeutics for the animal health rights to Aratana’s recently approved drug, Galliprant, for the control of pain and inflammation associated with osteoarthritis in dogs. Under the terms of the agreement, Aratana will receive an upfront payment of 45 million dollars and additional payments upon achievement of certain development, regulatory and sales milestones up to 83 million dollars, as well as co-promotion fees and royalty payments.

Fast-forward 18 months to June of 2016, when Sanofi and Boehringer Ingelheim (BI) announced the signing of contracts securing an asset swap strategic transaction that
was initiated six months earlier that involved the exchange of Sanofi’s animal health business (“Merial”) and BI’s consumer healthcare (CHC) business. The transaction is expected to close by year’s end, subject to regulatory approval.

According to the joint press release by both parent companies, combining Merial and BI’s animal health division, Boehringer Ingelheim Vetmedica, Inc. (BIVI), complementary portfolios and technology platforms in anti-parasitics, vaccines and pharmaceutical specialties would not only make the combined company the second largest animal health company after Zoetis, but will also put it into a more competitive position in some of the key growth segments within the animal health industry.

In order to complete the deal, BI has agreed to sell its vaccine manufacturing site in Fort Dodge, Iowa, and divest its previous acquisition (from Fort Dodge Animal Health) of its US companion animal and rabies vaccine portfolio, which includes its fourth largest animal health brand, canine Duramune, as well as Ultra Duramune, Bronchi-Shield and Bronchi-Shield Oral. On the feline side, BI will divest Fel-O-Vax, Ultra Fel-O-Vax and the Fel-O-Guard businesses.

Not to be completely sidelined, Merck Animal Health, the second largest animal health company prior to the aforementioned BI acquisition of Merial, acquired 93% of the shares of the privately held Brazilian Vallee, having annual sales of over 100 million dollars and with core competencies in cattle foot-and-mouth vaccines and access to several markets in South America.

In addition to R&D and market positioning pressures, the expectation is that we will see many more “geographical” acquisitions in the next few years, not only from well-known companies like Merck but also from lesser-known regional players based in other parts of the world, like China, for instance, to help them gain access to markets in the US, Europe and other parts of the world. Companies in China are aggressively targeting access to these markets through acquisitions, mergers and other types of structured deals. Such deals will also help fuel the unrelenting growth and need for more advanced technologies and innovation within the Chinese animal health market itself.

With those M&A activities completed, the top three animal health companies Zoetis, Merck Animal Health and BIVI (with Merial) will have approximately 50% of the total animal health market, up from approximately 40% just over two years ago. Our expectation is that the top animal health companies will continue to emphasise their core capabilities, shoring up weaker parts or divesting them for others over the next few years.

As the animal health industry matures the “eventual” top three companies may end up with as much as 70% or more of the market, and the sector may experience an even higher degree of consolidation. However, leading firms in a highly consolidated industry sector must find ways to stay at the top and grow in a mature sector; for that, they will likely spawn new growth of their own by spinning off new businesses.

The intense current M&A activity at the top of the animal health company list is only matched by the intensity and the sheer number of smaller companies at various stages of development, with or without products that have come to the fore in the past few years. As an example of the expansion at the bottom of the list, the Kansas City Animal Health Investment Forum, the premier event in the global animal health industry, has seen the number of applications to present increase to 48 for this year’s event, with a total of close to 300 companies applying to present over the past eight
years. Not only has the number of applications increased, but the quality, breadth of the technologies and segments of the animal health market represented have also increased. Other similar global events have either been held recently, such as the European Animal Health Investment Forum in February of 2016 in London, or will be held soon, as is the case with the Animal Health Asia event to be held in Hong Kong in October of 2016, both organised by Kisaco Research. All in all, these events provide the perfect opportunities for smaller companies to get noticed by investors and acquirers alike, adding fuel to the ongoing M&A fire.

Many experts and industry observers wonder if all of this M&A activity in animal health is coming at the expense of R&D? Are we stifling the very innovation that leads to great discoveries and indeed in many cases great returns, by allowing M&A deals that inevitably limit competition? The answer to both questions is ‘No, not necessarily’.

Like forest fires, M&A deals and the general process of consolidation within an industry can have a negative outward appearance of eliminating competition and innovation and in some cases they do; however, in my view, we should really be more worried about the granting of sweeping broad patents in that regard. Also like forest fires, M&A deals between industry giants offer a chance for renewal, a means to “trim the fat”, reduce redundancy and eliminate less effective products from the marketplace. Furthermore, when it comes to smaller companies, it is true also that some larger companies have the capacity to crush them and they sometimes do. However, there is such a wide base of innovation in startups and early-stage companies that larger companies, if successful in eliminating some, will not be able to eliminate all – in fact, in many cases they will opt to partner with them or emulate them, which is an overall benefit for innovation. One also has to clearly state that most startups view an acquisition by a larger company as a natural exit strategy. An acquisition may be the death of a startup, but in fact it can be the true commercial birth for the technology in question; the technology that the startup was championing from the beginning. In my view, innovation doesn’t go away and is not limited by M&A activities, it is just shifted from one player to another in response to market pressures and the natural evolution of an industry in growth mode, more akin to handing the baton rather than to a knockout punch.

The animal health industry will continue to move through the consolidation curve for the next 5 to 10 years. Case by case, there will be winners and losers, and it will be interesting to see who will remain at the top and who will disappear; however, as an industry sector, animal health will continue to grow, not only because of the value it no doubt has, but also to keep up with the unrelenting demands of an increasing world population and the unavoidable changes brought in by advances in technology. It’ll be an exhilarating ride and a good time to be in animal health. Enjoy.

Dr. Sam Al-Murrani, CEO, Babylon BioConsulting LLC, a human and animal health-based consultancy firm specializing in valuations, investor outreach, due diligence, business development and intangible asset management. He is also Managing Director for Bimini LLC, a privately owned manufacturer of pet dose-form health supplements and health treats.

Email: murrani@babylonbioconsulting.com