CORPORATE FINANCE

JANUARY INSIGHTS PAPER – PHARMA SERVICES

Increasing Cost and Complexity of Pharma R&D is Driving the Evolution of the Pharma Services Ecosystem

Market overview

The Outsourced Pharma Services sector performed well during the COVID-19 pandemic and has subsequently shown resilience in a harsh macroeconomic environment.

Supported by interest from both strategic and financial investors, deal volumes and values have surpassed broader market trends.

Platform assets of significant scale and specialised assets, providing early-stage access to pharma clients, carry additional scarcity value in this dynamic landscape.

Strategic buyers continue to drive deal activity as they favour M&A over organic growth to gain access to key clients, increase scale and expand capabilities across the drug discovery lifecycle.

Pharma Services, especially those assets which are tech-enabled, remains a desirable category to PE as they look to deploy substantial dry powder into this high margin sector, with PE-backed buy-and-build assets continuing to deliver substantial returns.

Revolutionising pharmaceutical development: the surge of outsourced services in a changing landscape

MedComms

Discovery & Pre-Clinical Trial › Clinical Research › Approval › Development › Manufacturing › Packaging & Distribution › Sales & Marketing ›

CROs | Regulatory Consultancies | CDMOs

The Outsourced Pharma Services market has experienced significant growth in recent years, driven by the pharmaceutical industry's increasing focus on core competencies and cost efficiency. Contract Research Organisations (CROs) and Contract Development & Manufacturing Organisations (CDMOs) play pivotal roles in this market, offering services ranging from drug discovery and development through to manufacturing and post-market surveillance. The market has also seen the emergence of integrated service providers offering end-to-end solutions, further simplifying collaboration for pharma companies.

Key factors contributing to market growth include the rising complexity of drug development, the need for specialised expertise and the pursuit of faster time-to-market solutions. Outsourcing allows pharmaceutical companies to tap into external specialised resources, accelerating the drug development process and reducing operational costs. The COVID-19 pandemic has further emphasised the importance of outsourcing in maintaining resilience in the pharmaceutical supply chain. The pandemic also acted as a market disrupter by accelerating the decentralisation of clinical trials. Pharma and Biotech companies are likely to continue leveraging outsourced services to navigate uncertainties and focus on core competencies.

Note: CROs: Contract Research Organisations, CDMOs: Contract Development & Manufacturing Organisations (CDMOs), MedComms: Medical Communications Agencies

Resilience and opportunities in Pharma Services M&A: navigating economic challenges and sustained investor interest

Pharma Services deal volumes have outperformed the broader market which has been hampered by the challenging macroeconomic environment. Both strategic and financial investors continue to actively seek opportunities within the sector.

2023 posed considerable challenges for investors with macroeconomic pressures, including significantly higher interest rates, reducing deal volumes across all sectors due to restricted access to leverage. Consequently, there was a notable 29% year-on-year decrease in deal volume across all sectors, with only 34,159 M&A deals completed across all sectors in 2023. Additionally, aggregate deal value for all M&A transactions in the year decreased by 23% from 2022, totalling $2.9 trillion in 2023[1].

In contrast, the Pharma Services M&A market exhibited impressive operational resilience during the COVID-19 period, as the sector was buoyed in particular by Big Pharma's increased investment into R&D and the knock-on effect this had on the expansion of the drug development pipeline. As such, the sector actually experienced a surge in transactions during the pandemic, driven by appetite to acquire resilient assets, resulting in increased valuations. Although there was a drop in transaction volumes in 2023, the Pharma Services sector remained stable despite global supply chain challenges and inflationary economic pressures. In the European Pharma Services sector, 15 deals were disclosed in 2023, only marginally down from 16 in 2022 and 17 in 2021[2].

However, Pharma Services transactions did face challenges relating to pricing mismatches between buyers and sellers, stemming from the macroeconomic shocks in 2022 that persisted into 2023. Sellers anticipated strong multiples post-COVID-19, whilst bidders adopted lower value positions, owing to increasing economic uncertainty. Notably, the average multiple of transactions in the MedComms market has decreased from the peak high of 15-16x seen during to the pandemic to below 15x at present, which is still higher than the pre-pandemic average of 12x[2].

Despite these challenges, the sector has maintained steady volumes as operators seek to acquire scale and capabilities across the drug discovery lifecycle. Both large Pharma Services corporations and PE-backed companies continued to acquire innovative small and mid-cap firms to enhance their offerings, gain technical expertise, enter new markets, diversify their client base, and access skilled staff, with M&A remaining a preferred route for achieving these objectives quickly and cost-effectively. This aligns with the trend of larger corporates becoming comprehensive 'one-stop shops' in order to make them more relevant to their customers, driven by Pharma and Biotech companies' desire to work with fewer and larger service providers. This strategic approach was exemplified by the full-service CRO ProPharma Group having made nine acquisitions in the last three years, expanding its geographical reach in Europe, India, North and South America and expanding services in areas such as digital transformation, medical writing and medical devices consultancy.

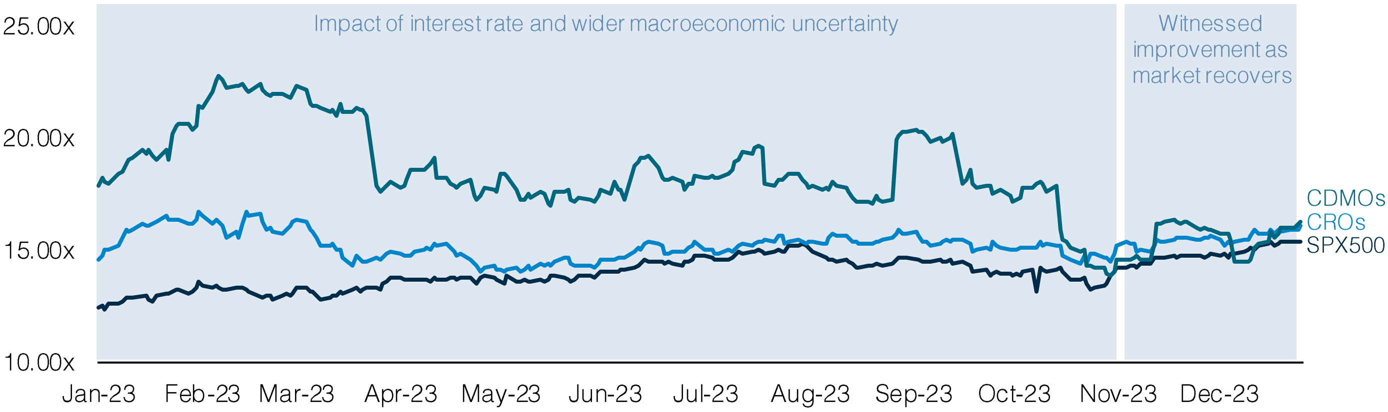
Since the transaction boom post-pandemic, there are also increasing numbers of PE-backed assets in the market who are pursuing buy-and-build strategies to elevate their offering to Pharma companies. An example of this is Sovereign-backed Bioscript who has made three acquisitions since investment in March 21 to increase its geographic footprint and extend into adjacent strategic services. The market has also seen an increase in international buyers transacting in the UK market, particularly those buyers based in North America, Europe and Asia. A recent example is US Linden-backed Aptitude Health's acquisition of Bamboo Medical Communications, a UK MedComms agency.

The Pharma Services sector's repetitive and predictable revenue nature, resilient market drivers, and high technological barriers to entry has driven the demonstrable and significant interest exhibited by PE and the wider financial investor pool, heightened by the attractive margins and growth potential through service offering and market share expansion. In Europe, over nine PE-related deals were disclosed in 2023, reflecting persistently strong multiples[1]. Noteworthy transactions included take-privates such as Arsenal Capital's acquisition of Cello Health (now Lumanity) at a value of $227 million (an implied EV/ EBITDA multiple of 13.5x) and CD&R's take private of Huntsworth at $680 million (an implied EV/ EBITDA multiple of 12.2x). A recent example is Permira's take-private of Ergomed in November of last year, valued at $870 million.

The continued interest from both strategic acquirers and financial investors has enabled the Pharma Services sector to demonstrate volume resilience compared to other verticals, leading to a scarcity of high-quality small to mid-cap assets which is expected to drive valuations as demand exceeds supply.

Note: 1. A&M Analysis, 2023; 2. Mergermarket 2023

Historical EV/ EBITDA multiples



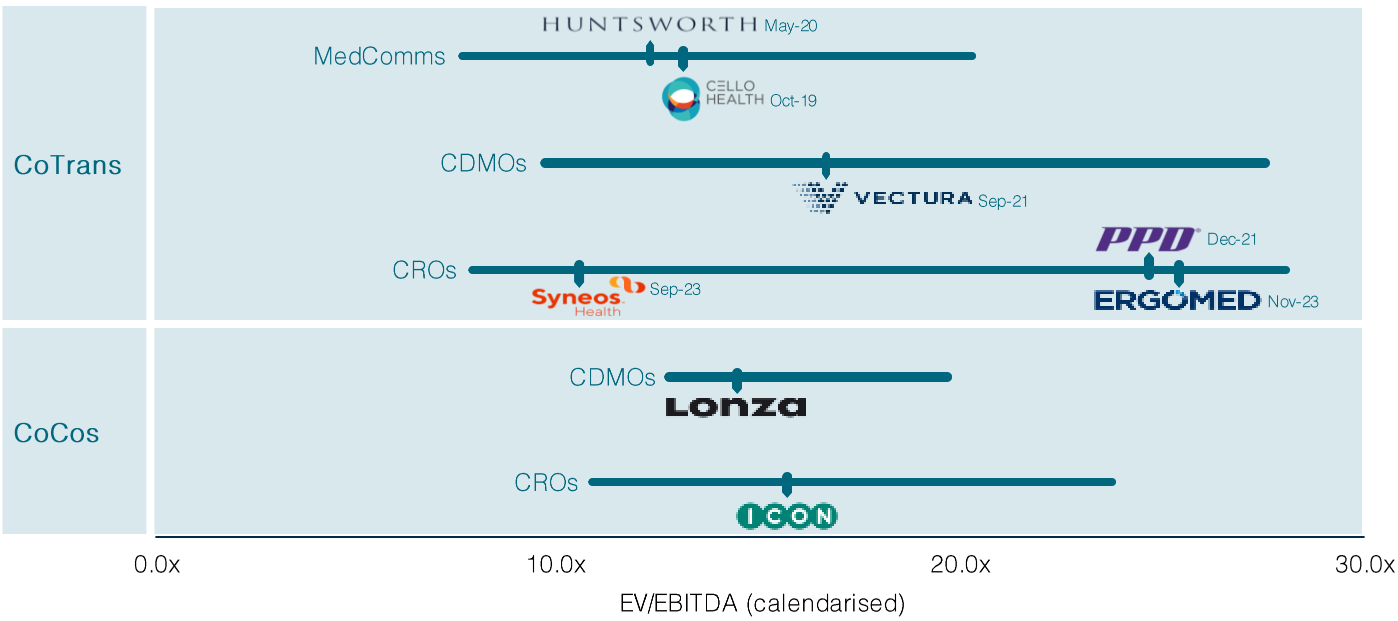
Source: A&M analysis, CapIQ

Whilst valuations in the Pharma Services sector have fallen from the post-pandemic highs, CROs and CDMOs quoted peers have maintained relatively strong EV/ EBITDA multiple performance over the last 12 months, tracking consistently above the S&P 500, albeit showing signs of convergence through Q4 2023 at c.15x.

Below is an analysis of EV/ EBITDA multiples across the Pharma Services sector for the last 5 years, demonstrating strong sector wide multiples.

For the purposes of this analysis, we have focussed on CDMOs, CROs and MedComms.

Selected Public Comparables and Transactions



Source: A&M Analysis

Sector outlook

While the challenges observed in 2023 persist, there is optimism for improvements in the broader M&A market in 2024. The lessening in uncertainty surrounding the trajectory of interest rates, coupled with a notable decrease in inflation has enhanced visibility and improved the market confidence in the upcoming months. Additionally, there are indications of a gradual resolution of the pricing mismatch, as bidders incorporate the lowering inflation and interest rate constraints into their valuation models and, in conjunction, sellers have adjusted to more current valuations following the post-pandemic highs.

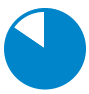
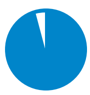
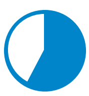
Although debt financing is becoming easier to price and therefore more accessible, interest rates are still higher than they were in 2021 meaning that debt remains relatively expensive. As a result, buyers are increasingly turning to private credit funds for funding. However, whilst debt remains costly, the substantial dry powder within PE funds, estimated at $2.59 trillion globally[1], is expected to drive further PE M&A activity. Creative deal-making approaches, such as higher cash contributions and minority stakes are likely to be employed as funds seek deployment opportunities.

In an increasingly positive market, Pharma Services assets are expected to remain attractive as confidence in inorganic growth continues to increase for strategic players and PE-backed assets aim to enhance their services for increased competitiveness. Following previous market consolidation, attention is increasingly devoted towards technically-advanced and early-stage areas such as innovative early-stage CDMOs and clinical trials work. Amidst industry consolidation, opportunities endure for innovative, value-added, and scalable assets. Corporates are keen on early-stage prospects, anticipating steady valuations with premiums for such assets and recognising scarcity value in un-consolidated ones.

However, as economic conditions improve, there is a potential shift in capital towards non-Pharma Services assets, attracting interest in sectors dependent on favourable economic conditions. PE firms may diversify their portfolios across sectors. The prospect of a General Election in H2 2024 could spur heightened deal activity across all sectors in H1 2024, as business owners seek to finalise disposals before any potential changes in the tax environment.

Despite the demonstrable resilience of the Pharma Services sector, driven by favourable demand drivers, businesses in this domain are expected to face intensified competition for capital from other sectors as the economic environment improves. This highlights the increasing focus on exit planning for Pharma Services asset owners as they navigate evolving market trends.

Buyer landscape

Buyer Group	A&M view on acquisition capacity	Rationale	Examples of recent acquirors
Corporates		Likely to prioritise growing inorganically as market conditions improve. The acquisition rationale to expand their offering, acquire technical expertise, reach new markets, diversify their client base and gain access to staff is expected to continue.	IQVIA, Lonza
PE-backed trade		There are numerous PE acquirors in the market pursuing buy-and-build strategies to expand their product range, grow their market share and increase returns. This strategy is likely to continue in 2024 but could be particularly selective depending on the timing of each fund's investment cycle.	Sygnature Discovery, Lumanity
PE		High levels of dry powder following time of market uncertainty. Interest is expected to continue in technically complex, niche and high-value areas of the market but risk of recovery of other investment areas diverting interest away from this sector. Debt is still expensive, reducing capacity for PE to leverage deals.	North Edge, EQT, Inflexion

Note: 1. S&P and Preqin estimates

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Reference list / bibliography

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