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Glaxo-Novartis deals show swaps not mergers are the new normal

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GlaxoSmithKline and Novartis today engaged the parking brake on the era of the pharma megamerger and hit the accelerator on divestitures as they executed a complex swap to rid themselves of their weaker links. The surprise announcement this morning reveals that Novartis will get Glaxo's oncology drugs while Glaxo picks up Novartis's vaccines line, and the two will combine consumer health businesses with Glaxo as senior partner.

The Swiss group also seized on the opportunity to sell off its animal health subsidiary to Lilly. The shape of the deals is yet another sign that big pharma sees less opportunity to create value by combining forces in traditional mergers and more in hiving off underperforming units.

"The problem with the massive transactions of the past is that they've had two or three interesting elements, but seven or eight that you'd rather not have to worry about," Glaxo's chief executive, Andrew Witty, said this morning. "In terms of value creation they turned out to be less compelling than people probably thought at the time. We don't have to be distracted by all of the other things that might come along in a traditional big merger."

Not the deal of the century

Investors appeared to be happy with the scale of the deals as shares in both European companies were up today – Glaxo 6% higher and Novartis up 2% in mid-afternoon trading. It did not hurt Glaxo that the deal would be accretive to earnings per share from the first year of its closing in 2015. Thanks to net cash returns of $7.8bn, it plans a £4bn ($6.7bn) buyback of class B shares to help earnings along initially, and revenue growth should finish the job, Mr Witty said.

The only investors who appeared to be unimpressed by the state of affairs were Lilly's, who also had in their decision-making matrix this morning the first FDA approval for the cancer antibody Cyramza (ramucirumab). UBS analyst Marc Goodman wrote today that the $5.4bn acquisition of the Novartis animal health unit looked expensive compared Pfizer's with Zoetis spinoff. Lilly shares were down 1% at $60.46 in mid-morning trading.

Neither Glaxo nor Novartis expects antitrust issues because the overlap between the companies is minimal. Novartis will need to find a separate buyer for its influenza vaccine business since Glaxo has its own, but Novartis's chief executive, Joe Jimenez, told investors that he was confident one would emerge; the unit is loss-making, but only because the group has been investing in R&D.

In pulling off its side of the respective deals, Novartis has managed to eliminate nearly all of its non-core businesses, with the exception of flu vaccines and the 37% of the consumer health business that it will retain. The core units – pharma, the Alcon eyecare group and Sandoz generics subsidiary – have more global scale and can promise better growth.

What Glaxo gets for its $5.3bn payout and potential for $1.8bn in milestones to bring on board the Novartis vaccines business is, importantly, Bexsero. At $631m in forecast sales in 2018, the meningitis B preventive does not figure as one of Novartis's top 10 drugs, yet analysts see it as the third-biggest growth driver in the vaccines space after Pfizer's Prevnar 13 and Sanofi's PENTAct-HIB, according to *EvaluatePharma* data.

It would be added to Glaxo's portfolio of paediatric, hepatitis, influenza and pneumococcal vaccines that include Pediarix, forecast to be the fourth-biggest seller in the space in 2018 at $1.7bn. The acquisition should help secure Glaxo's position at or near the top of the vaccine sales rankings (*How the oncology and vaccines spaces will look after pharma's game of musical chairs, April 22, 2014*).

Kiss it goodbye

It is more surprising that Glaxo chose to eliminate its marketed oncology division following the coup last year of approvals for the melanoma drugs Tafinlar and Mekinist, the latter becoming the first MEK inhibitor to be launched. As Mr Witty points out, however, oncology represents just 4% of Glaxo's sales, and perhaps would perform better in the hands of a company like Novartis that is near the top of the table in cancer care.

Novartis will pay $14.5bn, with another $1.5bn milestone due should the Combi-d trial, which pits Mekinist and Tafinlar together against Tafinlar monotherapy in melanoma, prove successful. In that event, the trial would help validate Mekinist's value, because its single-agent use is limited by toxicity and lower efficacy compared with Tafinlar.

Glaxo is, however, retaining its cancer R&D capacity, but as part of the transaction will give Novartis "preferred" partnership position in any successful compound.

The third leg to the Novartis-Glaxo transaction spree was the consumer merger. As a combined unit, its sales will still not quite threaten the undisputed king of this space, Johnson & Johnson, but it would solidify second place. It would not take much for the combined group to vault over J&J – with M&A talk surrounding another UK group, Reckitt Benckiser, for example, another $5.2bn in forecast 2018 consumer health sales might be there for the taking.

Big pharma emerged from the patent cliff under different pressures than it had going in – on the input side skyrocketing acquisition prices as biotech valuations have boomed, and on the output side pressure to keep pharma prices down. With choice limited, the next best option is to rationalise the assets they own. There might not be another deal of this scale, but expect targeted divestitures to continue.

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