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SPECIAL REPORT

R&D Drives Company Value

While R&D and quality control (QC) may not be "sexy" drivers of company valuation like brand name, image and recognition, market share dominance, and financial performance, they are the foundation that protects and nourishes the growth of a company.

by David T. Thibodeau

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I am often asked: "XYZ company was sold at a XX multiple; but, I have a much better company, so my company should sell at or above that multiple—right?" Of course the transaction the person is referring to is the latest blockbuster sale that hit the headlines with extraordinarily high multiples. My response is not what they're expecting to hear. I explain multiples are merely points on a board; they are the final product resulting from an analysis of a long list of value drivers and, conversely, value detractors. In recent years, actually since the VMS (vitamins, minerals and supplements) market crashed in the late 1990s, research and development (R&D) and quality control (QC) have been major components of the overall value driver/value detractor equation. Let's dive into how these R&D and QC components play a role in the value equation.

The sexy part of valuations and the headline grabbers are brand name, image and recognition, market share dominance, and financial performance. R&D and QC generally are not headline makers unless there is a problem, and therein lies the significant importance and role these "relatively mundane" activities play in the valuation equation. Based on more than 20 years of completing transactions in this industry, I believe these activities are the engine that powers the other, more sexy drivers. They give the product or brand the license to pound their chest and provide the supportable claims used by marketing and sales to differentiate their products. These activities are the foundation and fortress that protects and nourishes the growth of a product, a brand, a company. Without them, the business is built on a foundation of cards, to be knocked down with a mere hint of an FDA or FTC action, or, worse yet, a significant consumer complaint, injury or death. And don't forget the plaintiff's lawyers who are just waiting in the wings for any opportunity to file a class action suit. The more sophisticated investors or strategic buyers recognize the mission critical nature of these activities and will take a deep dive during due diligence to satisfy themselves that the company meets and, more often than not, exceeds standards set by government regulatory bodies, industry standards or self-regulatory organizations.

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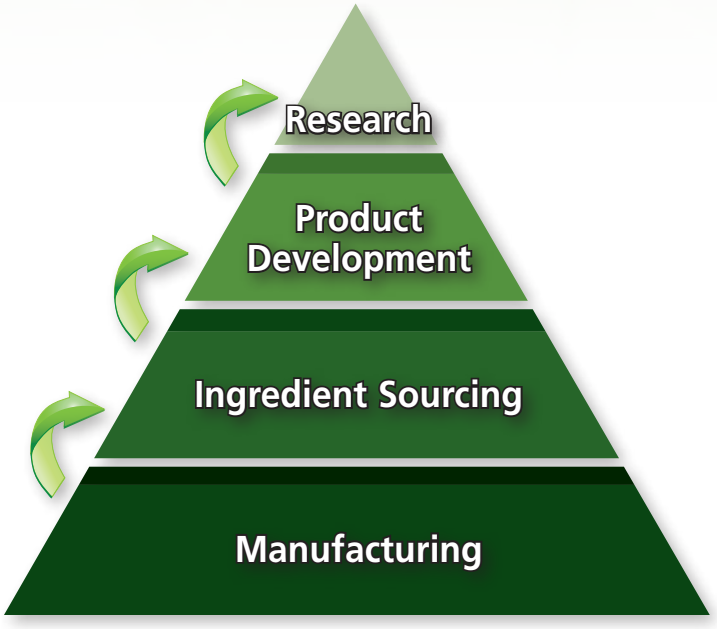
If you, the reader, are part of the R&D/QC function, I am singing to the choir. All others—pay attention, because cracks in the system can and do cause myriad problems from negotiated transactions being re-priced (and not higher!), significant delays in closing while the problem is being cured, increases in escrows and indemnification, or even a collapse of the purchase.

Let's start with the "R" in R&D. Most VMS manufacturers or marketers don't undertake much actual primary research. They rely on organizations that have the capability, such as universities and ingredient suppliers, to do this primary research, file the patents and undertake



some degree of clinical testing. Given the vast sums of money and risks involved, this approach is understandable and an accepted practice. Therefore, few VMS companies actually own the underlying patents; more often than not, these patents are licensed. Buyers accept this practice but, as always, the devil lies in the details. The stronger the underlying patent and/or license agreement and the broader the geographic coverage, the more it will contribute to the value equation.

Enforcement of the patent plays a significant role in the value creation process. The value of the patent will be diminished if your competitors are infringing and you are not enforcing. There are often change of control provisions in these licensee agreements that can significantly delay transfers or, even worse, negatively affect royalty arrangements. We have seen transactions where there are multiple inventors listed on the patents, some of whom are at odds with their co-inventors and who, out of spite, won't agree to the transfer of the patent/license. You can imagine what happens to a transaction in this case, particularly if it is a key patent/license.

Next up is the "D" in R&D. Common practice is to use licensed ingredients, compounds or a "unique" combination of ingredients to create a proprietary product to be marketed under a nifty new "brand" name. This area is fraught with potential value detractors. The astute company will do all it can to reduce or eliminate any potential problems before they become investors/owners. If the problem/issue can't be resolved, it is important to have a plan for resolving it and/or being up front with the buyer that a potential threat exists. Of course, one has to make a judgment call on the relative importance of a threat, but never assume it's not a threat or dismiss it as not relevant. I highly recommend the use of third-party experts to provide advice and guidance and, importantly, choose experts who don't have a vested interest in the outcome of the potential transaction. Different classes of buyers have vastly different views on issues ranging from solid science and research that the product/compound works and the clinical trials backing up claims,

its source and its efficacy to name just a few. We have seen instances where a product is the number one or two in a category and an issue surfaces that quickly knocks it out of that position, significantly derogating company value. An astute buyer is looking to minimize that risk, and if during due diligence they find these risks do indeed exist—and remember, it's their perception of the level of risk that counts—be ready for a re-trade on price, closing delays while the problem is being cured, an increase in escrow/indemnification, or, in the worst of all situations, the buyer walking away. It's critical to commit or re-commit to making this activity a high priority, even if you don't have plans to attract investors or sell the company in the near future.

You are feeling pretty good about now because you believe (and, hopefully, rightly so) that your company will pass these tests and your foundation is rock solid. However, we have only touched on the first two levels of the pyramid. The next level is raw material sourcing. The federal dietary supplement cGMPs (current good manufacturing practices) do not apply to raw material suppliers, but to finished product manufacturers; therefore, this is an area that generally raises red flags with investors/buyers. This industry has had its share of issues with ingredients ranging from contamination to adulterated product. Ultimately the responsibility rests with you, no matter where your company or products fall within the overall value chain. An investor/buyer is buying your company, and to some degree your supplier/supplier relationship, so at the very least it is critical to have established protocol around raw material procurement. If the potential investor/buyer can check his due diligence boxes and gain real confidence in your company's procurement and quality control/assurance capabilities at this stage, you will be driving company value.

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The manufacturing tier is the largest and the one that you have the most control over, particularly if you are the manufacturer. In this situation, any serious investor/buyer will undertake an exhaustive audit of the entire facility and process. Think of this audit like an FDA and customer audit wrapped into one. The intensity and thoroughness will vary depending on the class of buyer (pharma, VMS, food, etc.). By demonstrating along each phase of the manufacturing process that cGMPs and industry standards are being met or exceeded, you will establish a level of confidence in the buyer that will directly translate into value. Even though a buyer will look to be indemnified against any potential problems while you were in control of the company, they are equally concerned with the negative fall-out from a potential FDA/FTC action or some other calamity related to the manufacturing process. Nothing has a value-deflating effect like an FDA action, consumer complaint, injury or death, or a highly publicized class action lawsuit.

If you use a co-packer or contract manufacturer, it is incumbent upon you to undertake the same rigorous audit protocol, not only so you can sleep at night, but to be able to address any potential issue(s) the buyers will uncover during their audits—and uncover they will. There are generally abundant co-packer choices and, more often than not, if the price seems too good to be true it probably is. And you will end up paying for it in the long-term with a hit to valuation. I have seen many transactions go sideways because the manufacturer did not pass a buyer's audit or significant

issues existed even though the manufacturer met minimum standards. Often, the transaction comes back to life after tough negations between the buyer and seller, but always with a hit to valuation and a significant negative effect on deal momentum.

A strong commitment to R&D and QC have become one of the many key drivers when considering company valuation in both public and private transactions. Between stepped up FDA/FTC scrutiny and high profile transactions gone bad over the last decade, investors and buyers are going into transactions with open eyes, stepping up due diligence and balking at the first evidence of potential problems. Investors and buyers are simply not willing to risk their company's reputation and capital in companies that don't meet or exceed their R&D and quality control criteria. ❑

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